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The Manufacturers Hanover
Economic Report

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NOVEMBER 1984

The Window Is Open

Now that the elections are over, the Administration and the Congress must address two critical questions dealing with the economy. The first is, will the budget deficit shrink of its own accord? The second, if not, should we worry about it? I will tell you the answer right up front—and it's not just my opinion alone, but rather, the opinion of the overwhelming majority of people in the economic, financial, and business communities. No—the deficit will not go away unless something is done, and if it doesn't go away there may well be big problems down the pike.

The first thing to keep in mind, of course, is that the deficits referred to here are projections. As was noted in the September Economic Report, both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) agree that the Federal Government's budget will remain in the red through the year 1989—and by a substantial amount. CBO's deficit projection for 1989 is $263 billion, while OMB's is some $124 billion less—but a huge deficit, nevertheless. Both agencies have used what they consider to be reasonable assumptions regarding economic growth and the revenues it throws off, Federal spending, inflation, interest rates, and changes in current laws governing taxes and spending.

Growth Assumptions Are Optimistic

Let's examine the growth assumptions because these are clearly critical. Neither OMB or CBO expects a recession during the 1985-89 period. Coming on top of the two years of economic recovery just completed, this would mean a seven-year expansion. Only once in the past 130 years did the economy grow uninterruptedly for such a long period of time. That was, of course, the 106-month expansion that started in February 1961 and lasted until December 1969. The only other expansion that comes even close to it was the 80-month expansion which began in June 1938 and lasted until February 1945.

Both expansions, I might add, are considered by the National Bureau of Economic Research to have been wartime expansions. And periods of war, the record shows, tend to lengthen expansions by an average of one year. Since the current period is peacetime in nature, it would be quite an accomplishment if the ongoing expansion lasted seven years: The longest peacetime expansion in history lasted only 58 months, while the average postwar peacetime expansion has lasted only 34 months.

Thus, if anything, both these projections might be too optimistic in terms of the contribution that economic growth can make to Washington's coffers. Besides this, there is the rate of growth itself. The Administration projects that the real gross national product will expand by an average annual rate of four percent per year over the next five years following a two-year average growth rate of about 5½ percent so far in this expansion. Again, there have been periods of time when the economy has grown this fast or faster—but they were wartime. In 1949-53 the economy grew at an average annual rate of five percent; in 1962-66 the rate of growth was 5.4 percent. Growth rates during peacetime have averaged only 2¾ percent in the postwar era.

Notwithstanding this, some economists think that a new age has dawned and that we can grow—not only at an average annual rate of four percent per year for the next five years, but by as much as 5.5 percent! The reason I mention this latter figure is that if we were to grow at this rate, the deficit would almost be eliminated by 1989, using the Administration's assumptions as outlined in the September Economic Report.

Those who think these high-growth estimates are realistic point to what they believe are changes in productivity and its impact on the potential of the economy to grow. They claim that the stagnant economy of 1979-82, and, more recently, the low-inflation, strong-dollar environment of 1983-84 have made both management and labor aware of the need to increase efficiencies to save companies and jobs. The technological revolution of the past few years which has led to widespread use of computers, word processors, robotics and the like has further boosted productivity, they claim. The faster productivity

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grows, the faster the potential of the economy to grow and the faster the economy *can* grow before capacity constraints enter the picture causing either slower growth, a pickup in inflation, or both.

Once again it is necessary to look at the record. In the postwar era, private business sector productivity has grown at an average annual rate of less than 2½ percent. In the early 1950s, private business sector productivity grew at an average annual rate of more than 3½ percent, but this slowed to the point where in the 1970s the growth rate averaged about 1½ percent. So far in the 1980s productivity has been growing at less than even this low rate—recoveries, the strong dollar, and technological revolutions notwithstanding. Thus, while it might be possible to rev up the economy to grow at a rate of 5½ percent (or even more, for that matter) over the next few years, it would seem that, in the absence of a significant improvement in productivity, this kind of growth rate would eventually lead to rapid inflation and another boom-bust cycle.

Interest Continues To Pile Up

Another thing to keep in mind is that as long as the Government keeps running budget deficits, the cost of servicing the Federal debt will continue to rise. As I observed in September, interest outlays, which last year totaled $90 billion (11 percent of Federal spending and 46 percent of the budget deficit), are projected by both agencies to rise substantially over the next five years. By 1989, interest outlays could total anywhere from 80 to well over 100 percent of the budget deficit—making it virtually impossible to *ever* eliminate the budgetary red ink. Indeed, as early as next year, net interest expense could very well equal all outlays for such discretionary programs as grants to state and local governments, including education and highways; foreign aid; the cost of Federal government operations; energy, research and development; services to individuals, including housing assistance, student financial aid and veterans' medical care.

There has been a lot of talk about what is controllable and what isn't controllable when it comes to government spending. In reality, there is only one uncontrollable government expense: interest. Given enough time and appropriate legislation, the government can cut any other expenditure—but it must meet its debt-service payments or face default.

If these arguments are credible and the deficit will not shrink of its own accord, then the question becomes: Should we worry about it? I say we should. The discussion above regarding interest costs alone should make one concerned about the consequences of continued deficits. The Administration forecasts rising interest outlays even though it projects interest rates falling on an annual average basis starting in 1985. It is difficult to understand how the White House can forecast lower rates when there would appear to be only three ways in which the deficit can be financed—each one of them suggesting high interest rates.

The government can borrow from abroad. This, of course, is possible only if U.S. interest rates in real terms are higher than those overseas. Indeed, this has been the case for more than four years and is the primary reason why the dollar has gone up by more than 70 percent during this time on a trade-weighted basis. Needless to say, besides the high interest rates involved, a strong dollar has adversely affected many industries that sell goods abroad or which compete with goods imported from abroad. Of course, by reducing the number of jobs available, this impacts our domestic economy, thus personal incomes and the ability of people to spend. You can see where this would adversely affect economic growth.

If Washington were to confine its borrowing mainly to the domestic financial markets, chances are interest rates would be even higher. High interest rates, of course, would affect those industries which are sensitive to the price and availability of money. These include but are not limited to housing, autos, big-ticket consumer durable goods—not to mention the cost of educating one's children, and so forth.

Finally, if the government were to borrow from the Federal Reserve, it would also lead to high interest rates—only this time through an acceleration of inflation. While inflation does tend to benefit debtors at the expense of creditors, in recent years interest rates have ridden far enough above inflation so as to alter this somewhat. Notwithstanding this, one wonders if more rapid inflation is what the supply-side economists have in mind, especially since they seem to keep talking about the "depressed" price of gold and other commodities.

To be sure, there are those who say that the deficit has helped the economy over the past couple of years and that the economy has been able to grow with slowing inflation even in the face of the huge amounts of red ink. All of this may be true—but it is past history. The deficits helped the economy—but only after they hurt it by absorbing increasing chunks of savings in 1981 and 1982 at a time when the Federal Reserve was holding money tight. Once the Fed loosened up, the stimulative effects of the deficits were allowed to work and the economy moved from recession to recovery. The 1981-82 recession, coming so soon after the recession of 1980, along with the strong dollar, which got that way because of high real interest rates, were the main reasons why the rate of inflation has come down as sharply as it has.

However, as I said before, all of this is past history. Now that the economy is growing, the government's financing needs are in competition with that of the private sector

and the extent to which it results in high interest rates is keeping interest-sensitive sectors from growing and is also affecting our foreign trade. Inflation may remain low as a consequence, but so will real growth. And let us not forget the fact that the annual cost of servicing these deficits, the interest cost, is rising steadily.

Suggestions For Cutting The Deficit

With this in mind, I would like to offer some suggestions as to how the deficit can be reduced given economic, financial and political realities. On the latter, it is clear that voters overwhelmingly rejected the tax increase proposed by Walter Mondale. President Reagan, as you know, has also weighed in against using tax increases to help close the budget gap. Cutting spending alone is not the answer, either, since only 15-20 percent of the budget is controllable at any one time given current laws, contractual obligations—and, of course, the level of interest payments.

Still there is no doubt that any effort to reduce the deficit has to begin with government spending since this is the true burden that Washington places on the economy. One way or another the private sector has to give up purchasing power in order for the public sector to spend. If Washington borrows from the financial markets, there is less money available for others and interest rates go up. If Washington raises taxes, people also will have less money to spend. And if Washington should borrow from the Federal Reserve, then the ensuing rise in the rate of inflation cuts everyone's purchasing power in the process.

Having said that, it seems to me that the only way out of this dilemma is for a combination of strategies. It is fairly evident that we cannot rely on spending cuts and tax increases alone to do the job. Let me outline what I think should be done.

Freeze Federal spending. By this, of course, I mean in real terms, letting nominal spending go up with the rate of inflation. It may not be easily achievable in the next few years since only a relatively small proportion of the budget is controllable due to existing laws, and so forth. However, as you can see from the example in the table, it does pay spectacular dividends in the form of less growth in government spending, and it might be acceptable to the greatest number of people, since they would know that every recipient of government outlays would be affected similarly.

Reduce interest rates. Interest rates in the CBO projections are still high relative to inflation. Some of this might be eliminated as progress is made on the budget deficit. But some could also be accomplished by a further easing on the part of the Federal Reserve. Surely, the Fed has room to ease further in the current context: The producer price index has fallen for three consecutive months for the first time since 1967; the money supply is currently at the bottom of the Fed's annual target range (unnecessarily constraining Fed policy for 1985, since the average of the current quarter forms the base for next year's target bands); there is still the problem of country debt and confidence in the U.S. banking system; and there should be some degree of ease to offset the fiscal restraint that would come from any efforts at closing the deficit gap. As you can see from the table, just a two-point drop in interest rates compared with CBO's assumptions would by 1989 lower government spending by $54 billion annually.

PATHS TO A BALANCED BUDGET

		Projections				
	1984(a)	1985	1986	1987	1988	1989
CBO Baseline Receipts	667	751	811	881	965	1042
CBO Baseline Outlays	842	929	1006	1097	1203	1305
CBO Baseline Deficit	−175	−178	−195	−216	−238	−263
Outlays less:						
Freeze real spending with 4% inflation		−53	−95	−150	−218	−281
2-Points lower interest rates		−10	−20	−30	−44	−54
1-Point more growth		−1	−4	−9	−17	−28
Adjusted outlays		865	887	908	924	942
Receipts plus:						
Cancel indexing		+5	+16	+30	+45	+63
2-Points lower interest rates		−2	−2	−2	−2	+2
1-Point more growth		+8	+22	+38	+56	+77
$5 tax per barrel of oil		+10	+10	+10	+10	+10
VAT @ 5%		+50	+50	+50	+50	+50
Adjusted receipts		822	907	1007	1124	1240
Difference: Adjusted receipts − adjusted outlays		−43	+20	+99	+200	+298

Sources: Congressional Budget Office; Treasury Department; MHT Co.

(a) actual

More economic growth. There is no way that the budget can be balanced if the economy is allowed to slip into recession. And while CBO does not project a recession over the next five years, it does project a relatively modest growth rate of 3.2 percent. Raising that by one percentage point—a possibility if other steps outlined here are taken—would cut outlays by $28 billion by 1989 and raise revenues by $77 billion at the same time.

Tax imported oil. With oil prices clearly under pressure, a tax on imported oil could accomplish several positive things at one time. For one thing, it would add to government revenues both from taxing imported oil as well as from the windfall profits tax that would occur as the price of domestic oil matches the level of imports. In the context of falling prices this would not add to inflation. Also, such a tax would keep oil prices high enough to continue encouraging our efforts to conserve.

Broaden the tax base. Several ideas are kicking around regarding broadening the tax base. Some profess to be

revenue neutral—but it would seem to me that Congress would be unlikely to do battle with lobbies, special-interest groups, and so forth just to wind up with no net gain in receipts. Besides, even if such a bill were to be fashioned, it would not mean that everyone's tax bill would remain the same, since those who lose their loopholes are unlikely to be made whole by lower tax rates because usage of loopholes varies, as you can imagine. It was very hard to get estimates of the revenue effect of broadening the tax base from the sponsors of the two major bills in Congress. Newspaper accounts have one of them adding only the relatively modest amounts of $20-$30 billion a year by 1989. What I did instead was inserted a value added tax (VAT) at five percent.

Cancel indexing. With inflation down significantly, it might not be a bad idea to cancel the provision scheduled to take effect in 1985 which adjusts the tax brackets to take into account the previous year's inflation. When the rate of inflation was in double-digits several years ago, such an indexing provision might have made sense, for it would have assured that people whose incomes went up only because of inflation would not wind up worse off as a result of moving into a higher tax bracket. These tax brackets, you will recall, are "progressive" in nature and were designed at a time of little or no inflation. But today's low rate of inflation means that movement in between these tax brackets has slowed considerably. Yet, as you can see from the table, there is a sizable revenue loss after a while.

If one were to reduce outlays and add to revenues by all the means suggested, one could come up with a budget that would be balanced during 1986 and would be nearly $300 billion in surplus by 1989. I don't think this is likely any more than I think that we will have the CBO baseline deficit of $263 billion at that time. However, if we could arrive at a combination of spending cuts and revenue enhancements that would split the difference, we would have a balanced budget by decade's end.

Balancing the budget is not impossible. It can be done if our elected officials have the will to do so. Right now the window is open. In the wake of his impressive victory on Election Day, the President's influence with Congress will never be greater. Yet at the same time, he is forever removed from the political process since he cannot succeed himself. Many members of Congress will not be returning to Capitol Hill in January. It would seem to me that now would be the most opportune time for starting concrete action to bring the budget deficit down.

The suggestions presented above are by no means intended to represent the only paths we can take to a balanced budget. But they do show that we can move in the right direction if we do more than just cut spending and raise taxes—both of which obviously raise political hackles. The path to a balanced budget may not be an easy one to take, but I would remind you of the answer that the great entertainer, Maurice Chevalier, used to give each time he had a birthday and he was asked how it felt to be getting older. His answer: It "... isn't so bad when you consider the alternative."

The same is true with the need to find the way to balance the budget. The path may be torturous—but considering the alternative it isn't so bad. ■

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DECEMBER 1984

The Tail Wags The Dog

Time was when economists paid literally no attention at all to our foreign trade position when analyzing and forecasting the gross national product. It's not hard to see why: Although exports have accounted for about 6½ percent of the real gross national product in the postwar era, imports equalled more than five percent on average, so the actual contribution to the economy—what economists call net exports—was a relatively minor 1½ percent. Since this was well within the range of error insofar as forecasting GNP levels is concerned and, because its small size meant it didn't have much of an impact on the quarterly changes in the GNP, few economists made any serious attempts to forecast net exports—much less analyze and understand them.

All this has changed. While exports' share of the GNP has remained about the same, imports have shot up to the point where they now exceed exports by a considerable margin. As measured in the GNP accounts, the U.S. ran a deficit in its inflation-adjusted exports of goods and services in each of the first three quarters of 1984 with the deficit growing significantly through the year. Notwithstanding what you may have been reading about our deficit on the balance of payments basis, in the GNP accounts such a deficit is rare. In fact, before this year, the only other time in postwar history that net exports adjusted for inflation were in deficit was in the last quarter of 1971 through the second quarter of 1972. Then, the total amount of red ink in our foreign trade was $2.5 billion (1972 dollars). That was about one-third the size of the trade deficit run during the first quarter of this year alone, when real imports exceeded real exports by $8.3 billion. This proceeded to widen to a gap of $11.4 billion in 1984's second quarter—and then it more than doubled to $27 billion in the third quarter of 1984.

You have to put this into perspective to get the significance of this trade gap. First, as you will recall, the real gross national product which rose at an annual rate of 8½ percent in the first half of this year slowed dramatically to an anemic 1.6 percent pace in the third quarter. Most of this slowing traced to the worsening of our inflation-adjusted net export position. If the trade deficit in the GNP accounts had done no more than remain at the second quarter's record high, the U.S. economy would have grown at a 5.5 percent annual rate in the third—three times as fast as it actually did.

Let me put it another way. Since the third quarter of 1980, when our real surplus on trade was the greatest, inflation-adjusted net exports have declined by $80 billion, a loss equivalent to nearly five percent of the real GNP. Without this decline, the economy would have been 18 percent larger in the third quarter of 1984 compared

EFFECTS OF THE STRONG DOLLAR ON SELECTED INDUSTRIES

	Production Employment (Thousands of Workers)			Trade Deficit (Millions of Dollars)			Imports As A % of Consumption		
	1979	1983	1984: November	1979	1983	1984: August	1979	1983	1984(e)
Automobiles	764	571	665	$11,061	$19,203	$25,011	22.0%	26.0%	23.0%
Communications Equipment (Radio, Television, Telephone)	347	321	343	3,218	7,474	12,149	29.5	41.1	40.0
Iron and Steel Products	380	211	211	6,076	4,924	8,280	15.2	20.5	30.0
Lumber and Wood Products	654	547	594	818	969	1,274	24.9	29.5	29.2
Metalworking and Machine Tools	271	193	219	143	344	793	23.0	32.5	37.3
Paper and Paper Products	535	495	512	1,564	1,324	561	13.0	12.6	14.2
Textiles and Apparel	1,888	1,625	1,671	3,581	9,025	14,053	32.6	45.5	50.0

Sources: U.S. Bureau of Labor Statistics; U.S. Department of Commerce; Ward's Automotive News; American Iron and Steel Institute; National Association of Forestry Products; National Machine Tool Builders Association; American Paper Institute; International Ladies' Garment Workers Union.

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with four years earlier; instead it grew by less than 12½ percent.

As you can imagine, this foregone growth in the economy represents rather substantial losses in sales, earnings, and jobs. The table shows that a number of our key industries have shrunk as a result of either a reduced ability to export or because of competition from abroad. More than two million jobs have been lost because of this deterioration in our foreign trade position.

Even more dramatic is the financial implications of these growing trade deficits. If present trends are not reversed, the U.S. will cease to be a net lender to the rest of the world and will become a net debtor. This will occur when the total value of foreigners' holdings of assets in this country exceeds the value of U.S. assets abroad. The way things are going, this will occur sometime in 1985. Shortly thereafter, assuming a continuation of present trends, our foreign debt will exceed those of Brazil or Mexico, currently the world's largest debtors. And if nothing changes in the next few years, our net external debt could approach $1 trillion by the end of the decade—more than the total owed today by all the developing countries in what is called "the debt crisis."

This is more than just an abstract notion. Instead of earning money annually on our foreign investments, we will be paying out money to foreigners with investments here. Of course, these are funds that would not be available for domestic use, but rather, will go abroad.

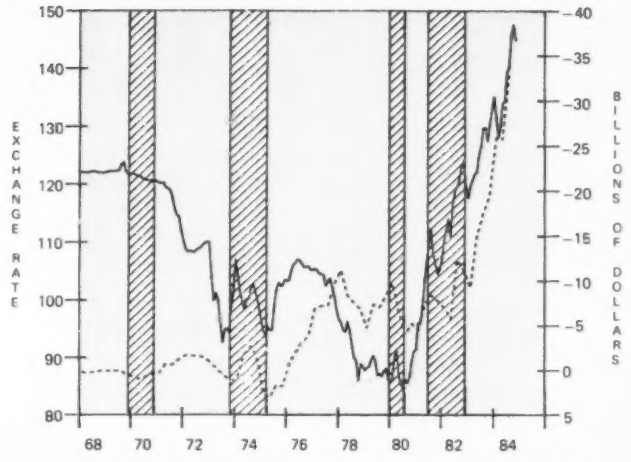
The Overvalued Dollar ...

It's not too difficult to see why our trade position has deteriorated. The U.S. dollar has climbed dramatically in value since the middle of 1980, as you can see from Chart I. On a trade-weighted basis, the dollar's value has climbed by about 70 percent since midyear 1980. It has gone from being an undervalued currency to one that is extremely overvalued. This overvaluation is largely—but not totally—responsible for the sharp turnaround in our trade position. Other factors that have caused our trade picture to deteriorate include the LDC debt crisis and the relatively anemic economies elsewhere in the industrial world.

Let me explain just what an overvalued dollar is, since there seems to be some confusion over this point. Some people would believe that the dollar's value in foreign exchange markets is whatever the markets say it is and that there is no such thing as an over- or undervalued dollar. This is not entirely correct. Because the markets clear at the end of the trading day does not necessarily mean that the various currencies are at their appropriate level any more than the price of any stock might be deemed by investors to be at its appropriate level when the exchanges close.

The best way to look at the position of the dollar is to

CHART I
U.S. DOLLAR TRADE-WEIGHTED EXCHANGE RATE (LINE)
VS. MERCHANDISE TRADE DEFICIT, BOP BASIS (DOT)



compare what can be bought in the U.S. with a dollar with what can be bought overseas. By our calculations, it takes roughly two D-marks to buy in Germany what one dollar will buy in the United States. Yet, in the foreign exchange markets, the holder of a U.S. dollar today can buy more than three D-marks. Plainly, this means that the dollar is overvalued against the mark and the mark is undervalued against the dollar. Here is another example. You can buy goods and services in Britain with one pound sterling that would take a $1.50 to buy in the United States. Yet the pound exchanges for only $1.17 at this writing. Again, the dollar is overvalued versus the pound while the pound is undervalued versus the dollar.

As it translates into world trading markets, it means that goods that are priced in dollars and sold abroad are extremely expensive to holders of marks, pounds, francs, yen, and so forth, while goods produced in those countries are extremely low in price when brought into the United States. One may argue over what method to use when calculating over- or undervaluations of currencies, but the bottom line is that the U S. trade position deteriorated soon after the dollar's value began to climb.

... Boosted By High Real Interest Rates ...

Having, I hope, settled this question, the next point that might be asked is what caused the dollar to rise as rapidly as it did? There may be a number of reasons why people will invest in dollars such as our strong economy, political stability, large and fluid financial markets—not to mention the freedom to move money in and out of the country at will. But these factors have always existed, yet the dollar was not always overvalued. Clearly, it would appear that there are other factors.

The first is the increased after-tax profitability of investments that has resulted from the 1981 change in tax depreciation rules. Second, there was the decline in the rate of inflation, which substantially reduced the effective tax rate on income earned on these investments.

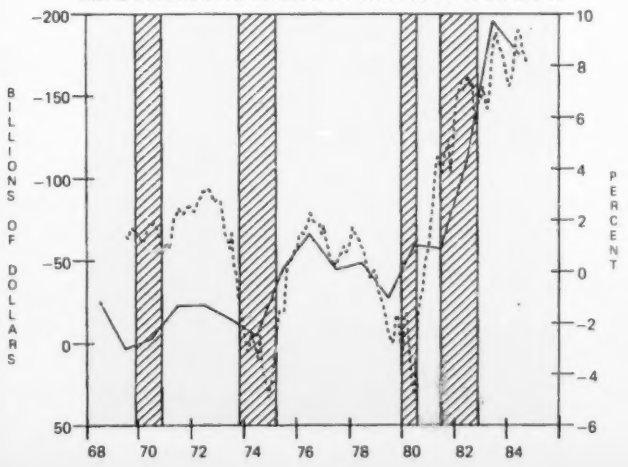
Meanwhile, sluggish recoveries elsewhere and higher costs have lowered pre-tax profitability in other countries to below that of the United States.

However, the key reason for the strong dollar seems to be the rise in real interest rates that has occurred over the past 4½ years. In turn, these appear to trace to the large actual and projected deficits in the Federal budget (Chart II). These deficits, of course, represent a need on the part of Washington to borrow in order to close the gap between spending and revenues. Not only are these deficits the largest in history in dollar terms, they represent the biggest share of GNP in the postwar era and the biggest chunk of net national savings as well. This alone would suggest that interest rates would have to be high in order for the Government to crowd out the private sector from the financial markets so that it could borrow to finance its needs. At the same time, however, the Federal Reserve changed its monetary policy from one that allowed inflation to one that has brought it down. Thus there was even less of a pool of credit available for Washington to borrow from than there might have been had the Fed continued to pursue its previous policy.

... Should Be Brought Down

The next question is what do we do about it? If our only focal point were the dollar's impact on economic growth, specific industries and jobs, there would be no question but that we should take steps which would depress the value of the dollar as quickly as possible. Since it has been established that high real interest rates are the cause of the strong dollar, it would seem logical that one way or another these real interest rates should be brought down. Because the Federal Reserve can influence the level of interest rates, the suggestion might be made that the Fed should pump more liquidity into the economy. This would undoubtedly lower both nominal and real interest rates. And if this increase in liquidity should produce more rapid rises in prices, then real interest rates would fall further, thereby reducing the attractiveness of holding dollars to foreigners and, in turn, causing them to get out of dollars and back into their currencies. All would presumably come out all right as imports became more expensive, exports more competitive, with the subsequent fillip to the U.S. economy.

CHART II
FEDERAL BUDGET DEFICIT (LINE) VS.
REAL INTEREST RATE ON 7-YR TREASURY NOTE (DOT)



But it's not as easy as all that. Too-rapid a fall in the dollar could not only take it back to an undervalued position, it could result in a new round of double-digit inflation, as a byproduct. For just as the strong dollar has helped reduce the rate of inflation by a substantial amount, it would be logical to expect that a weakened dollar would result in more rapid inflation. And if this were not enough, one must remember one key result of the dollar's rise in the first place: Its attractiveness to foreigners enabled Washington to finance some of its deficit abroad rather than in domestic markets. In effect, we would seem to be between Scylla and Chrybdis, when it comes to policy regarding the foreign exchange value of the dollar.

In my view, there is a way out. If interest rates were to fall because of reduced demand for funds by Washington to finance its deficit and not because of more money created by the Federal Reserve, I would bet that the dollar would float gently downward like a snowflake, rather than falling like a ton of bricks. My reasoning is simple: We would still be a low-inflation economy, one whose growth potential would be enhanced if Washington's borrowing needs were reduced, thus freeing up funds for the private sector. In this circumstance, there might not be as much additional foreign money coming into the U.S. as before —but at least it would not flee the dollar as might be the case were inflation perceptions to change in the wake of an extremely easy monetary policy. And whatever slowdown there would be in funds coming in from abroad might well be made up for by the reduced level of Government borrowing that would accompany a shrinking budget deficit.

If this sounds like another plea for Washington to get its act together and start working on balancing the budget, you are right. Sooner or later the tail will stop wagging the dog; the dollar will decline. If the Administration and the Congress can come up with a package that produces a balanced budget within a few years, this decline will not only not be injurious to the U.S., it will be helpful.

Let us hope that the New Year will bring a new attitude towards reducing the budget deficit on the part of our elected officials in Washington. If it does, it will truly be a Happy New Year for all.

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The Manufacturers Hanover
Economic Report

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FEBRUARY 1985

Business Conditions Update

By now, it should be clear to all but the most die-hard pessimists that the U.S. economy managed to skirt a recession last year and is once more on a fairly solid growth path. Not only was the Commerce Department's estimate of the increase in the fourth quarter's real gross national product nearly 40 percent higher than reported in the so-called "flash" GNP estimate, it was one and a half times the rate of rise in the third quarter. As pointed out in the October 1984 Economic Report, this speedup in growth in the fourth quarter provides a good jumping-off point for 1985. This jumping-off point is even higher than it looks, since monthly data suggest that economic growth accelerated toward the end of last year and continued early this year. This virtually ensures that 1985 will be another good year for the economy, when annual growth averages are taken into account. However, it would be a mistake to assume that the quarterly pattern of growth in 1985 will duplicate that of 1984, when growth was extremely strong in the first half of the year, weakening in the second.

Inventories and Foreign Trade ...

For one thing, inventory accumulation is not likely to contribute to GNP growth the way it did a year ago. Last year at this time there was a feeling in the business community that inventories had gotten too low relative to current and projected sales. In addition, there was a belief in some quarters that the rate of inflation would accelerate as it used to do during business expansions, providing another reason to stock up on goods. Business plans for investment in plant and equipment were strong and this sent a signal to a wide variety of industries to prepare for these demands. As measured in the GNP accounts, the change in business inventories in last year's first quarter added 6.5 percentage points to economic growth—nearly tripling the 3.6 percent rate of rise in real final sales.

This year is somewhat different. For one thing, retailers are shell-shocked from their experience during the 1984 holiday shopping season. In order to move merchandise many stores had to offer substantial discounts from intended selling prices. Merchants were left with large amounts of unsold goods which many are still trying to work off. This discounting, along with the low rate of inflation posted for 1984, has clearly changed the psychology from buy in advance to wait for lower prices. Business spending plans for capital goods may be positive for this year but they are certainly nowhere near as ebullient as they were in 1984. Finally, the demand for finished goods appears to be settling into a long-term trend rate of growth, since pent-up demands from both business and consumers that developed during the recession appear to have largely been satisfied—at least at current prices.

... Will Influence Quarterly Growth Rates

In addition, there would appear to be another reason not to expect the economy to bounce back smartly. This stems from our foreign trade position. As was pointed out in the December 1984 Economic Report, the unprecedented strength of the dollar has caused foreign trade to exert a major influence on our economic growth. The GNP table shows that, while growth in final sales in the fourth quarter compared with a decline in the third helped to boost overall GNP growth, another reason for the turnaround can be traced to the drop in our foreign trade deficit—which, of course, is less of a subtraction from the total real GNP. If the trade deficit in the fourth quarter as measured in the GNP accounts had equaled that of the third, real GNP would have gone up by only one percent instead of the nearly four percent it did because this was the rate of growth in real domestic demand. This can be seen in the GNP table, since we are including real domestic demand for the first time right underneath real final sales. Note, by the way, that by removing the effects of foreign trade, you can see that real domestic demand grew at a progressively slower pace during 1984.

While we are expecting a pickup in real domestic

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demand during the current quarter, we think that this will be offset by a widening of the trade deficit. This is because the dollar today is stronger than it was in the fourth quarter—and it was extremely strong in the fourth quarter, anyway. It is difficult to say with certainty why our trade deficit shrank in the fourth quarter compared with the third at a time when the dollar was strong. I would think, however, that it reflected the earlier slowdown in final sales. If this is the case, then the fourth quarter's pickup in final sales should result in a greater influx of imports during the current quarter, leading to the widening of the trade deficit depicted in the GNP table. In other words—the influence of foreign trade has to be taken into account when forecasting much more so than used to be the case. And if recent trade patterns are any guide, overall GNP growth could oscillate more than it used to.

Another contributor to this roller-coaster economy is the relationship between fiscal and monetary policy. Because fiscal policy appears to be locked in the full-throttle position, the role of controlling the economy has been assumed entirely by monetary policy. The Federal Reserve seems willing to let interest rates go up when economic growth gets strong—but is quick to push them down when growth appears to be stalling. Since economic data are available with a lag and since the economy responds to changes in interest rates with a lag, you can see another reason why the economy has adopted this stop-go characteristic.

The Federal Reserve Will Remain Generous ...

I would like to point out, however, that this role as policeman of economic activity is not entirely a new one for the Fed. In actuality, it is similar to the role the Federal Reserve had prior to October 1979. The Federal budget was in surplus only twice in the previous 20 years, so most of the burden of managing the economy had fallen on monetary policy. From October 1979 through midyear 1982, the Federal Reserve shifted to the monetarist approach to conducting monetary policy. This meant it placed greater reliance on controlling the money supply and less on such other factors as interest rates. While both the Fed and the monetarists would agree that this was not an experiment in pure, automatic-pilot monetarism, it certainly was closer to it than anything the central bank had ever done.

The Fed moved away from its monetarist experiment in the middle of 1982, adopting a more eclectic approach to monetary policy. It eased dramatically as the risks of worsening recession appeared to far outweigh the risks of inflation. The Fed thus sent interest rates lower, the stock market higher, and the economy bounding out of recession by the end of 1982. By May of 1983, when it had become apparent that the economy was safely out of recession and firmly entrenched on the recovery road, the Fed let interest rates rise in order to keep this growth from getting out of bounds. As business activity slowed a bit in the second half of 1983 the Fed let interest rates move lower—but the pickup in growth in first-half 1984 saw interest rates once again move higher. The slowdown during summer 1984 was accompanied by another decline in interest rates, setting the stage for the bounceback in the economy toward the end of last year.

This is not to imply that the Federal Reserve is no longer paying attention to the money supply and to the inflationary potential of rapid growth in the money stock. The Fed still issues target ranges and seems to want the money supply to grow within these bands. However, it does not appear as though this is the Fed's primary concern at this time. Nor, for that matter, is inflation. Because the rate of inflation remained low in 1984 and seems likely to do so this year, too, Federal Reserve officials have stated publicly that they are prepared to tolerate more growth than they might have previously. In our view, inflation will remain low as long as the dollar remains strong. If the dollar were to weaken suddenly causing inflation to flare up, the Fed's tolerance for strong growth might diminish.

This brings up the next question: How much longer can economic growth continue, considering the imbalance between fiscal and monetary policy, the huge trade deficit, and the aging of the business expansion which makes it more susceptible to these and other developments than it was last year or in 1983? In my view, economic growth at varying rates will continue until:

- The dollar's strength weakens enough industries to cause the overall economy to lapse into recession, or;
- the dollar collapses, boosting exports and retarding imports, increasing capacity utilization and tightening labor markets. As price pressures develop, interest rates would jump—sending the economy into a recession, or;
- there is an accommodation on the budget between the Administration and the Congress which brings the deficit down and allows a better balance between fiscal and monetary policy. In this case, the path of economic growth would be smooth and the expansion could be quite long lasting.

Obviously, this kind of scenario makes planning ahead extremely difficult. Right now the key consideration for business, labor and investors is the low rate of inflation and how that impacts buying policies, wage and price decisions, as well as investment strategies. But this could change if the dollar's foreign exchange value should suddenly drop. Additionally, the rather large spread between short- and long-term rates continues to induce heavy reliance on short-term debt by the business sector. Businesses raised a lot of money in the short-term markets in 1984, in part a reflection of the lower cost compared with long-term funds. If the yield curve should flatten, business may be tempted to fund out, which would be good, since it would improve the state of their balance sheets.

... As Long As Inflation Stays Down

However, even if the yield curve does not flatten, business may have to finance in the longer term markets, anyway. This is because many banks will not have the appetite for making loans this year that they had in 1984. Bank lending policies will be constrained by the higher capital requirements that have been imposed by the regulatory authorities. It comes just at the point in the economic cycle when business needs for external funds are generally larger than earlier in the expansion, when sales and profits were growing more rapidly.

Therefore, even if the Federal Reserve is more tolerant of economic growth, thus more generous with the supply of money and credit, short-term interest rates may rise, anyway, because of the factors described above. On the other hand, long-term interest rates, which are very sensitive to inflation and the expectation of inflation, could very well trend lower for most of the rest of this year—again, assuming that the dollar remains strong, keeping inflation at bay. H

February, 1985

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1984				YEAR 1984		1985				YEAR 1985	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3553.3	3644.7	3694.6	3752.5	3661.3	10.8	3793.6	3860.4	3937.3	4032.8	3906.0	6.7
GNP: $72	1610.9	1638.8	1645.2	1661.1	1639.0	6.8	1665.4	1681.6	1701.6	1725.4	1693.5	3.3
% Change, Annual Rates	10.1	7.1	1.6	3.9	6.8		1.1	3.9	4.8	5.7	3.3	
Consumption	2276.5	2332.7	2361.4	2398.6	2342.3	8.6	2440.2	2481.5	2518.9	2571.1	2502.9	6.9
Durables	310.9	320.7	317.2	324.7	318.4	13.8	330.6	341.4	346.5	361.5	345.0	8.3
Non-Durables	841.3	858.3	861.4	872.1	858.3	7.1	882.5	890.4	899.8	911.5	896.1	4.4
Services	1124.4	1153.7	1182.8	1201.8	1165.7	8.5	1227.2	1249.7	1272.6	1298.1	1261.9	8.3
Investment	623.8	627.0	662.8	635.5	637.3	35.1	631.1	639.5	664.1	681.0	653.9	2.6
Non-Residential	398.8	420.8	435.7	448.9	426.8	28.7	454.8	460.5	466.8	474.5	464.2	8.9
Producers Durable Equipment	256.7	279.7	284.2	291.4	275.7	23.5	295.7	300.0	304.5	310.1	302.6	9.7
Structures	142.2	150.0	151.4	157.5	150.3	15.9	159.1	160.5	162.3	164.4	161.6	7.5
Residential	151.2	155.6	155.3	155.4	154.4	16.8	154.9	159.3	157.3	171.3	163.2	5.7
Inventory Changes	73.8	50.6	71.8	31.1	56.8		21.3	19.7	30.0	35.2	26.6	
Net Exports	−51.5	−58.7	−90.6	−64.3	−66.3		−78.0	−75.3	−74.7	−64.7	−73.2	
Government Purchases	704.4	743.7	761.0	782.7	748.8	9.1	800.4	814.8	829.0	845.4	822.4	10.0
Federal Defense	213.4	220.8	220.3	231.4	221.5	10.4	238.5	243.1	247.8	255.5	246.2	11.2
Federal Civilian	54.2	75.6	81.7	84.6	74.8	6.9	86.3	87.5	88.3	88.6	87.7	18.4
State & Local	436.8	447.4	458.9	466.6	452.4	8.8	475.6	484.2	492.9	501.3	488.5	8.0
Final Sales: $72	1579.3	1618.5	1614.6	1646.9	1614.8	5.0	1654.9	1672.2	1688.4	1710.6	1681.6	4.1
% Change, Annual Rates	3.6	10.3	−1.0	8.2	5.0		2.0	4.2	3.9	5.4	4.1	
Domestic Demand: $72	1619.2	1650.2	1672.2	1676.3	1654.5	8.7	1687.7	1703.4	1721.8	1740.9	1713.5	3.6
% Change, Annual Rates	12.9	7.9	5.4	1.0	8.7		2.8	3.8	4.4	4.5	3.6	
GNP Price Index (1972 = 100)	220.6	222.4	224.6	225.9	223.4	3.7	227.8	229.6	231.4	233.7	230.6	3.2
% Change, Annual Rates	4.4	3.3	4.0	2.4	3.7		3.4	3.2	3.2	4.1	3.2	
Consumer Price Index (1967 = 100)	306.8	309.6	312.3	315.3	311.0	4.2	317.9	320.4	323.0	326.1	321.8	3.5
% Change, Annual Rates	5.0	3.7	3.6	3.9	4.2		3.4	3.1	3.3	3.8	3.5	
Total Personal Income	2920.5	2984.5	3047.2	3100.4	3013.2	9.8	3134.2	3171.7	3223.7	3292.0	3205.4	6.4
Disposable Personal Income	2502.2	2554.3	2606.4	2649.4	2578.1	10.2	2683.7	2714.2	2756.7	2811.8	2741.6	6.3
Savings Rate	6.1	5.7	6.3	6.3	6.1		5.8	5.3	5.3	5.3	5.4	
Employment Rate	57.5	58.0	58.0	58.2	57.9		58.2	58.3	58.6	58.8	58.5	
Unemployment Rate	7.9	7.5	7.5	7.2	7.5		7.3	7.3	7.2	7.0	7.2	
Indus. Production (1967 = 100)	159.8	163.1	165.6	165.3	163.4	10.8	166.1	167.6	169.5	173.0	169.0	3.4
Housing Starts (000)	1968.0	1895.3	1663.7	1558.7	1771.4	4.8	1686.2	1812.0	1896.8	1902.9	1824.5	3.0
Domestic Auto Sales (000)	8162.3	8262.0	7966.7	7440.0	7957.8	17.1	8218.4	8345.2	8085.2	8422.9	8267.9	3.9
Corporate Pre-Tax Profits	243.3	246.0	224.8	222.9	234.2	15.3	213.2	223.8	234.3	249.7	230.2	−1.7
− Taxes	92.7	95.8	83.1	82.0	88.4		76.6	81.2	87.0	96.3	85.3	
Net Profits	150.6	150.2	141.7	140.9	145.8	14.5	136.7	142.6	147.2	153.3	144.9	−0.6
− Dividend Payments	77.7	79.9	81.3	83.0	80.5	10.4	84.4	86.6	88.9	91.4	87.8	9.1
Undistributed Profits	72.9	70.2	60.3	57.9	65.3	19.9	52.3	56.0	58.4	61.9	57.1	−12.5
+ Depreciation	287.5	296.4	306.4	317.2	301.9		327.1	337.2	347.1	358.0	342.3	
− Inventory Profits	13.5	7.3	0.2	1.7	5.7		2.9	2.0	6.1	13.0	6.0	
Net Cash Flow	346.9	359.3	366.5	373.4	361.5	17.5	376.5	391.1	399.4	406.9	393.5	8.8

Manufacturers Hanover completes another record year.

Extracted from a letter to shareholders by John F. McGillicuddy, Chairman.

"I am very pleased to report that our corporation's earnings reached a new high in 1984. In fact, our net income of $352.5 million represents this institution's 12th consecutive year of record results.

"Fourth quarter earnings totalled $106.2 million, an increase of 23 percent over last year's fourth quarter. Even more significant was the fact that our earnings per share for this period reached $2.14 up from $2.13 a year ago and $1.69 in the third quarter of 1984. This means that the dilution resulting from the issuance of common and preferred stock—both related to the acquisition of CIT Financial Corporation—has been reversed, and in only nine month's time.

"A major factor in this reversal was that CIT's performance more than lived up to expectations. Since it was acquired on May 1st, CIT has contributed $31.7 million to our bottom line—that, after all charges for interest-related financing costs and the amortization of the purchase premium. On a pro forma basis, had CIT been with us for the full year instead of only eight months, it would have contributed approximately $45 million. We expect CIT will contribute at an even higher level in 1985.

"Other highlights of the year worth noting include:

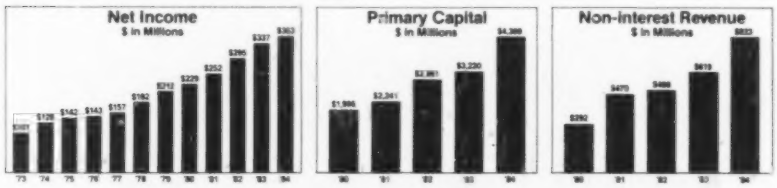
"A 35.7 percent increase in primary capital, up $1.2 billion to $4.4 billion. This brought our ratio of primary capital to assets to 5.77 percent, up from 5.01 percent a year ago. In the past three years, we have added $2.2 billion to our primary capital base.

"A $198 million addition to our reserve for possible loan losses. This 45.8 percent increase in our reserves came after absorbing a record $259.2 million in net loan charge-offs. This means that despite the impact of a grossly uneven economic recovery, both at home and abroad, we were able to absorb our losses out of current earnings even as we bolstered our reserve by an additional $198 million. At year's end, our reserve totaled $630.7 million, representing a ratio of reserves to total loans of 1.08 percent, up from .90 percent a year ago.

"A 33 percent increase in other operating income to $823 million. This $204 million improvement means that we continue to derive an ever-growing share of our revenues from fee-based services that make little or no claim on our capital ratios. Improvements came in virtually all sectors of our business, but were particularly strong in the areas of foreign exchange trading, securities trading and investment banking.

"On the international scene, progress continued to be made during the year, with a major debt restructuring for Mexico and with Argentina reaching agreement with the International Monetary Fund and major creditor banks. The result was a partial payment of past-due interest by Argentina at year's end. Despite this payment, our earnings for the year were reduced by $26.3 million after-tax by the impact of certain nonaccrual Argentine loans.

"Our strong performance in the fourth quarter, particularly given the challenges we faced, provides us with a great deal of momentum as we enter 1985."



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A full earnings report and complete financial statements are available pending publication of the 1984 Annual Report and 10-K in early March. Write Manufacturers Hanover Corporation, Corporate Communications Dept., 270 Park Avenue, New York, NY 10017.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

MARCH 1985

The Buck Stops—Where?

The continued strength of the U.S. dollar in foreign exchange markets has economists, corporate treasurers, and policymakers searching for explanations. To be sure, the original reason for the surge of investments into dollars—high real interest rates in the U.S. compared with other countries—still largely exists. However, the dollar's foreign exchange value has gotten so high that it has begun to exert a serious impact—not only on a number of key industries (Economic Report—December 1984), but on the U.S. economy as a whole.

This has led to several attempts by Washington and other world capitals to depress the value of the dollar by intervening in the foreign exchange markets. As you might have expected, these forays produced no lasting change in the dollar's value. Indeed, they may have contributed to strengthening the dollar by pointing up the difference in the amount of assets available to central bankers compared with those in the foreign exchange markets.

Intervention, of course, attacks symptoms rather than causes. Thus, concerted efforts by central bankers to depress the value of the dollar would work only if the markets were ready for a fundamental change in their attitudes towards the dollar. This change does not seem to have occurred just yet. For it would appear that real interest rate differentials are just the tip of the iceberg when it comes to factors behind the dollar's strength.

A Shift In The Flow Of Funds...

Because of these comparatively high rates of return, there has been an increase in investment funds coming in from abroad. While this inflow of foreign savings may have helped to ameliorate financial pressures in U.S. markets, they are by no means the only reason for the dollar's strength. Indeed, according to the Commerce Department's balance-of-payments statistics, (see table) total foreign net capital inflows last year were approximately the same as in 1981. By contrast, U.S. net capital outflows have declined dramatically during the past couple of years. Undoubtedly, whatever pulled in foreign savings also kept U.S. funds from going abroad. As noted earlier, high real interest rates no doubt played a role, but an analysis of the statistics would suggest that other factors entered into the picture as well.

SELECTED U.S. INTERNATIONAL TRANSACTIONS
Billions of dollars, seasonally adjusted
(Positive entries are inflows, negative ones are outflows)

	1981	1982	1983	1984(e)
CURRENT ACCOUNT BALANCE	**6.3**	**−9.2**	**−41.6**	**−96.6**
financed by:				
SELECTED CAPITAL ACCOUNT FLOWS				
Private Capital Inflows to the U.S.	**75.4**	**94.2**	**77.7**	**72.5**
Direct Investment	23.1	14.9	11.3	19.4
Security Purchases	10.1	13.5	17.3	21.0
U.S. Bank Liabilities to Foreigners	42.1	65.9	49.1	32.1
Private U.S. Capital Outflows	**−99.5**	**−123.9**	**−37.9**	**−2.5**
Direct Investment	−9.6	−4.8	−4.9	−0.5
Security Purchases	−5.7	−8.1	−7.7	−1.7
U.S. Bank Claims on Foreigners	−84.2	−111.1	−25.4	−0.4
All Other Capital Flows, Net	**17.8**	**38.9**	**1.8**	**26.6**

(e) First 3 quarters, annualized
Note: Numbers may not add up due to rounding
Source: Department of Commerce, *Survey of Current Business*

For one thing, American banks sharply reduced their new lending to foreigners. After growing by $111 billion in 1982, new bank claims on foreigners (mainly loans)

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increased by less than $300 million during the first three quarters of 1984. This more than offset the drop of $34 billion in new bank liabilities to foreigners (borrowings plus various types of deposit accounts) with the result that there was a turnaround of nearly $80 billion over this time span.

You don't have to look far to find the reason for this dramatic shift in the flow of funds. First there was the international debt problem. As you know, a number of countries experienced difficulties in servicing their debts beginning in 1982. As part of the workout process, they curbed their imports and took steps to boost their exports in order to run (or increase) a surplus on their trade accounts. Combined with reschedulings, which stretched out debt repayments over a number of years, this reduced the financing needs of these debtor nations. Another reason was the drop in oil prices, which cut the borrowing requirements of the oil-importing countries. Finally, the U.S. economy experienced faster growth than most other economies, and thus required more credit.

...For A Variety Of Reasons...

Obviously, the faster rate of growth in the United States than elsewhere offered greater opportunities for deployment of funds by others as well. These higher growth rates translated into an even higher rate of after-tax returns on investment because of the Economic Recovery Tax Act of 1981. ERTA raised the after-tax profitability of investment by liberalizing tax depreciation rules. Meanwhile, the Federal Reserve successfully convinced the financial markets that it was not going to monetize Washington's budget deficits and fuel inflation. Thus the real after-tax rate of return on investments was further enhanced.

To be sure, the combination of fiscal ease and monetary restraint did result in high interest rates—nominal as well as real—as I have noted in the past. However, financial deregulation and financial innovation made the U.S. economy much more resistant to high interest rates than it used to be. Financial deregulation eliminated the rationing effect which tended to cut back homebuilding at a fairly early stage in the recovery by allowing thrifts to pay more for deposits. At the same time, such financial innovations as variable-rate mortgages, by enabling the thrifts to maintain a positive spread between the cost of deposits and the returns on their loans, allowed them to deploy their funds profitably, further supporting residential construction—a mainstay of the U.S. economy.

It is this relatively new ability to grow rapidly at a noninflationary rate in the face of high interest rates that seems to be responsible for the turnaround in the international flow of funds. Reflecting better opportunities here than elsewhere, foreign net direct investment in the U.S. continues to run at high levels, while U.S. net direct investment abroad has dropped sharply. Insofar as indirect investment is concerned, foreigners have stepped up their purchases of U.S. securities while U.S. net purchases of foreign securities have declined as well. This is interesting, when you consider that U.S. citizens holding U.S. dollars have greater purchasing power abroad than foreigners with their currencies have here. It would seem that while foreigners are attracted to the enhanced after-tax rate of return available in the U.S., Americans may be pulling back from overseas investments because of the reduced rate of growth that exists outside the U.S.—not to mention the losses that occur when earnings in weak currencies are translated into strong dollars.

Focusing in on foreign economies for a moment, Japan, Germany, the United Kingdom, and a number of smaller European countries have been following fiscal policies diametrically opposite to those of the United States. Over the past several years they have been making strenuous efforts to reduce their budget deficits. Several have been successful—in particular, Germany, Japan and the United Kingdom. The problem is that these restrictive fiscal policies, along with comparatively tight monetary policies, have produced extremely weak economies. This is due in part to the speed at which these deficits were reduced and also because their savings rates are high—meaning no offsetting increase in spending by the private sector.

The Organization for Economic Cooperation and Development (OECD) reports that while the U.S. has been enjoying its strongest postwar recovery, the rest of the OECD area has been experiencing by far its weakest postwar upswing. This is ironic, considering that the reason these countries cut their budget deficits was to release funds to the private sector in order to lower interest rates and stimulate economic activity. However, while real interest rates overseas have generally fallen from their 1981 peaks and are now for the most part lower than that of the United States, they still remain unusually high, in view of the depth of the 1980-82 recession and the anemic nature of these countries' recoveries. These restrictive fiscal and monetary policies have only partially been offset by the strong stimulus other countries have been getting from their ability to sell more goods in the U.S. and other dollar-denominated markets.

...Is Keeping The Dollar Strong...

Therefore, as you can see, the strength of the dollar reflects a shift in financial flows due to a combination of developments both within and outside the United

States. While a major one—the shift by U.S. banks from net providers of funds overseas to net borrowers—may not persist, other factors leading to a scarcity of dollars outside the U.S. are likely to remain. As long as prospects for pre- and after-tax returns after taking into account potential currency changes look so much better here than in the rest of the world, the U.S. could continue to attract funds for quite some time to come. However, should the U.S. economy slow down and/or output rise more rapidly overseas, conditions favoring the dollar might well change.

Brighter prospects overseas might make foreigners less willing to invest in the U.S. and U.S. entities more interested in sending funds abroad—the costs and risks of foreign exchange notwithstanding. This would be especially true if other countries were to follow our lead and orient their policies toward high growth, low inflation, and reduced tax rates. Such a change is not impossible: Once other governments realize that their economic policies—instead of strengthening their currencies and their economies—are actually weakening them, they could easily reverse course.

Even before this happens, however, the direction of financial flows could change, for there is a limit to these capital inflows. Foreign investors cannot forever raise the share of their assets they put into dollar securities and investments. It is not clear what these limits are and when they are likely to be reached. What is less uncertain is that the U.S. has now become a net debtor for the first time in about 70 years. Its holdings of foreign assets are smaller than the foreigners' holdings of U.S. assets, requiring the U.S. to pay more in dividends and interest than it receives. This means we are now borrowing, not only to pay for our excess of imports over exports, but also to service our foreign debt—a situation similar to our domestic budget deficit, with its rapidly rising interest costs.

...But This Won't Last Forever

I suspect that these limits will be reached once people decide that they've got as much dollars as they care to hold, given current incentives. At that point, unless new incentives arise, the U.S. will have to stop going further into debt. Indeed, the U.S. will probably require a trade surplus just to pay its debt-service bill; it might have to run a current account surplus to reverse some of the damage that will be done to our foreign investment position and creditworthiness.

Obviously, running a current account surplus would mean that we would have to produce more than we consume. If we can get other countries to buy more of our goods than they're doing now, we will not have to restrain our domestic expenditures. Other countries might be willing to take more U.S. goods at current prices if their economies were to begin booming—something that plainly depends on their own decisions regarding fiscal and monetary policies. If we can't achieve enough of a surplus by getting others to buy more, we may have to buy less and that usually means recession. And if the current account deficit reduction is also accompanied by a fall in the value of the dollar, this will lead to a higher rate of inflation—which would push up the interest rates and probably produce a recession.

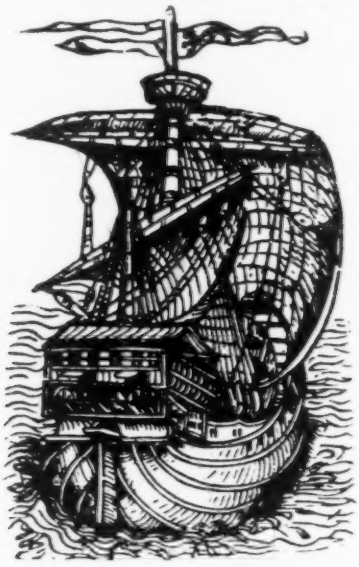
On the other hand, continued strengthening of the dollar could also produce a recession. A dollar that's even stronger than today would hurt more and more industries by making them unable to export and/or compete with imports. Eventually, enough industries would be declining to pull the entire economy down.

This is not to imply that there is no solution to today's version of the "dollar crisis." There is a way out—but it is not intervention, which is only temporary at best, and cosmetic at worst. Nor does it involve the U.S. deliberately screwing down its economy in order to dampen people's appetites for imports while reducing the price of goods we sell abroad. What it does require are fundamental changes in the U.S. economic policies and those of our trading partners. We must become more like them in some respects while they must become more like us.

Notice I said "in some respects." I don't mean that we should wind up growing more slowly and have more inflation like our trading partners overseas. What I think we should do, however, is to have a better balance between fiscal and monetary policy. This means, of course, reducing our budget deficit and offsetting it with a greater degree of monetary ease. Our trading partners, to offset the impact that our change will have on them, should ease their restrictive fiscal policies somewhat while keeping their monetary reins taut to hold inflation at bay. An easier fiscal stance abroad is feasible, given higher rates of private saving there than in the United States. These savings are available to finance the consequent rise in these countries' budget deficits from their current low levels.

The abnormally high value of the dollar is a symptom of a major disequilibrium in the world economy. It is the result of an inconsistent mix of monetary and fiscal policies being pursued by the United States and—in the opposite direction—by some of its major trading partners. To bring the dollar to a more appropriate level while minimizing the possibilities of either recession or inflation requires a better balance between monetary and fiscal policies both here and abroad—and a greater degree of cooperation and coordination between the major industrial economies of the West. H

Woodcut illustration from Columbus' letter to the Spanish Court, 1493



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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

APRIL 1985

Monetarism Versus Realism

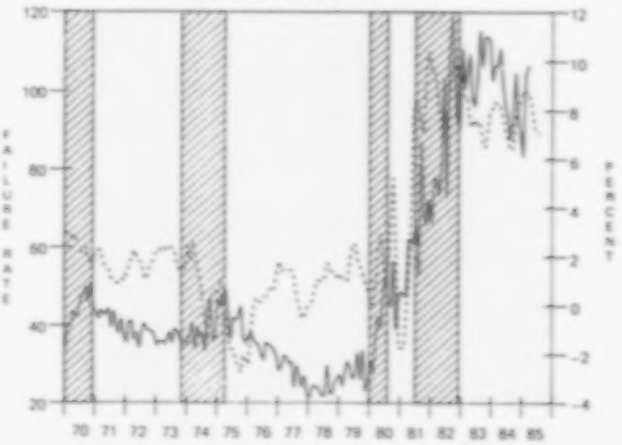
The first quarter's figures showing very slow growth in the real gross national product have once again focused the spotlight on the Federal Reserve. The central bank is being blamed for this slowdown by those who look no further than the top-line real GNP figure as well as by those who look beneath the surface. The 1.3 percent growth rate reported for the January-March period was not only less than one-third of the 4.3 percent annual rate of increase in the fourth quarter of 1984—it was also considerably below the 2.1 percent rate of growth reported by the Commerce Department in its "flash" GNP estimate released in March.

This shocked a number of economists who thought that the flash report was too low and that it would be revised upward. Since interest rates on most business and consumer loans remain in double-digits even though the economy has grown at a meager 2½ percent clip during the past three calendar quarters versus a sizzling seven percent pace in the previous six, and the rate of inflation is anywhere from 3½ percent down to zero, the Fed, quite naturally, has come under fire (Chart I).

Trade Deficit Depresses GNP

Those who look beneath the surface of this GNP report are no more mollified than their top-line counterparts. For a dissection of the numbers reveals that most of the slowdown was due to a widening of the trade deficit as measured in the GNP accounts (Economic Report—February 1985). Real domestic demand (real GNP minus net exports) rose at a 4½ percent rate in the first quarter compared with an increase of only 0.9 percent in the previous quarter (Chart II). While both the consumer and the business sectors participated in this advance, their purchases did not translate into corresponding growth in domestic output because a greater chunk of it was satisfied from abroad. After adjusting for inflation, imports in the January-March period soared by more than 26 percent while exports fell by more than eight percent. The strong dollar no doubt had a lot to do with this, and our high real interest rates compared with those of our trading partners had a lot to do with the rise in the value of the dollar to its overvalued levels.

CHART I
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE) VS. REAL PRIME RATE, MOVED 6 MONTHS FORWARD (DOT)



If this were all, the Fed's decision would be simple. It would just increase the rate at which it provides money to the economy and the result would be lower interest rates. This would clearly give a lift to domestic economic activity by bringing down the cost of borrowing, thus easing pressures on the credit-sensitive sectors. It might also help our foreign trade position to the extent that lower interest rates would reduce the value of the dollar. However, the Fed's choice is not so clear-cut. For the money supply is already growing rapidly and any further increase in the rate of growth of money could very well revive inflation and the expec-

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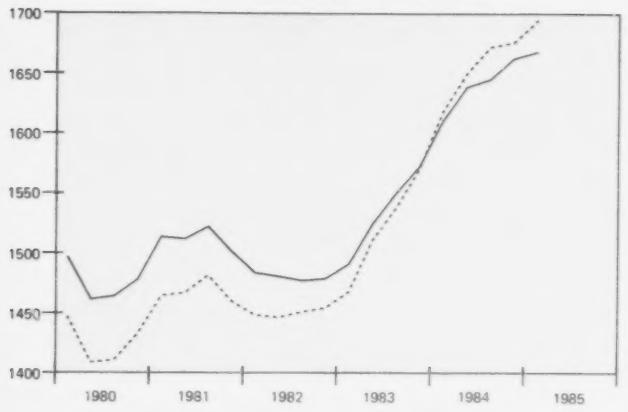
CHART II
REAL GROSS NATIONAL PRODUCT (LINE)
VS. REAL DOMESTIC DEMAND (DOT)
(BILLIONS OF 1972 DOLLARS)



tation of inflation—something the Fed has fought long and hard to damp down over the past five years.

This is not to say that the Fed isn't aware of its dilemma and is not trying to resolve it. It is. Back in February, in his semi-annual testimony before Congress, Federal Reserve Chairman Paul Volcker sent an important signal to the financial markets when he indicated that the conventionally-drawn targets for the money supply's growth should be altered (Chart III). The money supply was growing above the target ranges as they had been conventionally illustrated, but there was an obvious need to avoid tightening up.

The Fed Will Try...

Chairman Volcker indicated that the Fed should not be constrained by the cones which were narrow at the start of the year, widening only later on. He suggested, instead, parallel lines drawn back from the yearend boundaries: "We have sometimes considered, and others have suggested, a better 'pictorial' approach would be to illustrate the targets by a different (but also necessarily arbitrary) convention—parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period ... The target range is then portrayed as maintaining the same width throughout the year."

Using this procedure gives the Fed more room to manuever in the beginning of the year, as is fairly obvious. However, it is also obvious that this procedure allows for more liquidity to enter into the economy since the growth rate of the money supply earlier in the year can be greater than otherwise under the narrow, or cone-shaped targets.

The big question is: How much liquidity can the Fed inject into the economy before it runs the risk of firing up inflation and the expectation of inflation? Judging by the miscalculations of those economists who are of the monetarist persuasion, and who estimated that the U.S. economy would encounter double-digit inflation by the end of 1984 because of rapid money growth earlier in that year, the Fed would seem to have a fair amount of leeway. Obviously, what threw off the monetarists' calculations was the rise in the value of the dollar.

As has been pointed out in the past, the super-strong dollar caused inflation pressures to diminish in a variety of ways. First, it dampened demand for commodities worldwide, since most of these commodities are priced in dollars and thus required much more in the way of local currencies. This dampened demand for these commodities which depressed their dollar price, but not by as much as other currencies were falling against the dollar. In the U.S., the strong dollar restrained exports since they were priced too high to compete in world markets. At the same time it encouraged a sharp rise in imports for the opposite reason. The U.S. was inundated with more goods than before which not only lowered their prices, but also induced domestic manufacturers to keep their prices down in order to remain competitive. In turn, pressure was put on labor to restrain wage increases—effectively reversing the wage-price spiral of earlier years.

The Fed can't take too many chances with inflation psychology. Thanks to monetarism, the financial markets are very much aware of the money supply's growth rate—not only on a monthly or quarterly basis but on a weekly basis as well. Too much above-target money growth without a suitable explanation from the central bank would reawaken inflation psychology—the strong dollar notwithstanding. Such inflation psychology would reappear first in the bond markets, as long-term interest rates would rise. This would obviously put the kibosh on business capital spending, homebuilding and anything else that requires long-term credit.

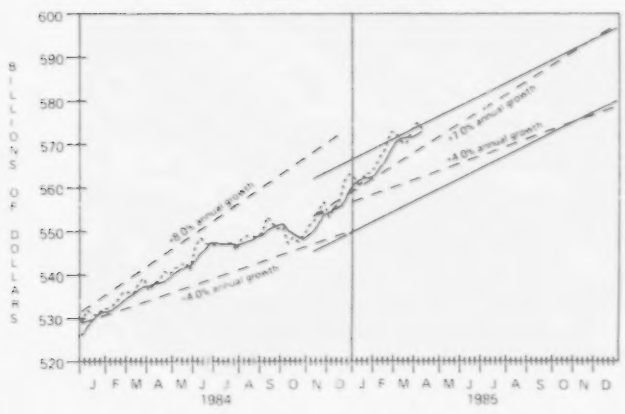
...To Keep Interest Rates Down...

By the same token, the extent to which the Fed might be successful in depressing short-term interest rates could very well precipitate another decline in the value of the dollar. In turn, this would reduce its restraining effect on prices. Plainly, the combination of excess liquidity already in the system as well as latent fears of inflation could easily be translated into higher prices as the flow of goods leaving this country picks up while the flow of goods coming in slows down in response to

changes in the foreign exchange value of the dollar.

I think the Fed will be a realist—not a monetarist. Besides the signal already sent to the markets by broadening the target bands, Fed officials have also pointed out that velocity, or turnover of money, has been lower than usual. "There is some analysis that suggests the trend of velocity over time may be a little lower than the trend of three percent or so characteristic of much of the postwar period when interest rates were trending higher," said Chairman Volcker back in February. "Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee (the Federal Reserve Open Market Committee) anticipates that those aggregates (the money supply in its various definitions) might end the year in the upper part of their ranges." In plain English, this means that the Fed might be prepared to accept even faster money growth if it is evident that the velocity or turnover of money is insufficient to move the economy ahead at a desired rate.

CHART III
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



Complicating matters are the well-publicized troubles that the Internal Revenue Service is having with its computer system. It has resulted in delayed payouts of refunds and a consequent swelling of Treasury balances at the Federal Reserve. This is causing the Fed to have to inject additional reserves into the commercial banking system in order to keep interest rates from rising as funds flow out of commercial banks into Federal Reserve accounts. Obviously, once the Treasury catches up and refunds go out, these funds will flow back into the banking system. No doubt this will boost money growth further, complicating the Fed's strategies and the markets' interpretation of them.

...So Business Can Grow

One thing seems certain: The Fed is not likely to tighten anytime soon. The last thing the Fed (and the economy) needs is for interest rates to go shooting up. Not only would such a development slow overall economic activity, but it would also hit hard at such sectors as those depending on foreign trade, homebuilding, and agriculture, to name three. On the other hand, it should be realized that the Fed can't keep interest rates down forever. The credit needs of a growing economy, combined with the needs of Washington to finance its budget deficit, will keep the demand for money strong. The Fed may accomodate these demands for a while, but it cannot be expected to do so indefinitely.

Once the Fed stops accommodating, interest rates will go up. One way or another after that, the economy will slow to the point of recession. Either higher interest rates will attract funds from abroad thereby driving the dollar up, depressing the foreign trade-sensitive sectors further, or these higher interest rates will strike the credit-sensitive sectors of the domestic economy first such as homebuilding, autos, and capital goods forcing the economy down in a similar mode.

The Ultimate Solution

The solution, then, lies not with the Federal Reserve, but with Washington and its budget deficit. The politicians are deluding themselves if they think that because the business expansion has made it this far while the deficit has grown and remained large, the economy can continue to grow even if nothing is done about Washington's red ink. For the deficit has already affected economic activity. By keeping interest rates high compared with inflation, it has hurt not only the credit-sensitive sectors of our domestic economy like autos and housing, but also our foreign trade position by attracting funds into this country, thus boosting the value of the dollar.

The next step is for Washington's budget deficit to actually throw the economy into reverse. This will happen if the deficit remains unchecked and the Federal Reserve decides that it can no longer avoid tightening up on the money supply. No doubt at that time the Federal Reserve will be the scapegoat once again.

However, those who would criticize the Fed should take a leaf from the comic strip character Pogo who said, "We have met the enemy and he is us." H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

MAY 1985

The Corporate Income Tax*

Practically from the moment of its inception in 1909, the corporate income tax has been the subject of considerable controversy. Economists have clashed repeatedly over who really pays it: stockholders, owners of capital in general, consumers, or labor. Other discussions have revolved around the impact of the corporate income tax on business investment decisions and how such investments are financed. More recently, the introduction of the investment tax credit and other preferences, along with the recent liberalization of depreciation allowances, have sharply reduced the percentage of total Federal tax revenues contributed by corporate income tax receipts. It has also come to the attention of the media and others that because of these various provisions, corporate income is not measured or taxed uniformly, thus causing effective rates of taxation to vary widely among firms and industries.

Not surprisingly, a number of people have set out to "reform" the corporate income tax. This has brought together such disparate groups as consumer advocates, academic liberals—and the Reagan Administration. Because it is unclear who actually pays the corporate income tax, and because Washington is faced with a budget deficit of monumental proportions, it is easy to see why corporations are tempting targets for a tax increase. But before such a change is instituted, it is necessary to examine very carefully what it would mean for the economy with respect to capital formation, productivity growth, inflation, and living standards in general, both in the short run and in the long run, as well.

Taxing The Privilege

It is not hard to see why the taxation of corporate incomes has occurred over the years. A business enterprise enjoys special privileges and benefits when it operates in the corporate form. These include perpetual life, limited liability of shareholders, liquidity of ownership through marketability of corporate stock, growth through retained earnings, and possibilities of intercorporate affiliations. Since these privileges exist because of Federal legislation, a corporate income tax was seen as a means for the government to share in the gains resulting from a government sanctioned form of business organization. Some people also claim that if there were no corporate income tax, people could avoid the individual income tax by accumulating income in corporations.

Initially taxed at a rate of only one percent, corporate income came to be regarded more and more as a source of government revenue than as a tax on the benefits of incorporation as government spending increased. During World War I, the tax rate on corporate income was increased to 12 percent. In 1936 the proportional tax was replaced with a graduated tax with rates from eight percent to 15 percent. By World War II, the maximum tax rate had risen to 40 percent, while in the Korean War it reached 52 percent. Tax rates have declined since 1969, however, repeated modifications of the rules for computing taxable income and tax liabilities have reduced the effective corporate tax rate even more.

Considering the controversy over who actually pays the corporate income tax, it is nothing short of amazing that both the nominal and the effective corporate tax rate have come down. While most businessmen would view corporate taxes as another cost of doing business—a cost to be passed along in the form of higher prices—there seems to be quite a lively discussion among economists as to whether or not this is true.

Short- vs. Long-Run

From here, it would appear that the question of who bears the burden of the corporate income tax depends on the period of time involved. Examining the corporate income tax by distinguishing between short- and long-run

*Based on a paper presented before the New York Academy of Sciences on May 7, 1985, inaugurating an Economics Section.

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time periods helps to narrow the differences somewhat. In the short run, the corporate income tax will either influence selling prices or not depending on the kind of markets in which businesses operate. Under conditions of the two extremes in competition—perfect competition or monopoly—business firms will seek to maximize net profits. The maximum occurs when the cost of producing an additional unit is exactly equal to the additional revenue obtained from the sale of that unit. A tax on economic profit makes no difference in this decision, since the tax applies to profits earned from the sale of all units—not profits from the last unit.

On the other hand, most of today's market structures are neither perfectly competitive nor monopolistic. Rather, they show considerable imperfection and mutual interdependence, or oligopoly. Under these circumstances, business firms tend to set their prices at the level that covers their full cost plus a margin for profits. In this instance, taxes are included in cost calculations. Alternatively, businesses might aim at an after-tax rate of return on invested capital. Thus, the imposition of a tax or an increase in the tax rate, by reducing the rate of return on invested capital, will have to be taken into account in making output and price decisions. In most instances, the incidence of the tax will be shifted forward to consumers in the form of higher prices.

In the long run, the corporate income tax appears to influence investment by reducing the rate of return on corporate equity. If business cannot shift the tax in the short run, after-tax rates of return are depressed and the incentive to undertake corporate investment is thereby reduced. These lead me to the next point, and that is the impact of the corporate tax on business investment.

In deciding whether to invest in a project, most managers begin by calculating the project's expected rate of return. This is then compared with management's objectives regarding the minimum rate of return required of these investment projects. Obviously, if the expected rate of return exceeds the required rate, the project will be undertaken. The expected rate of return on investment is derived from three factors: after-tax profits on the investment, the value of the depreciation deductions that can be taken over the life of the project, as well as its initial cost. Plainly, the greater the rate of after-tax profits, the greater will be the rate of return. By the same token, since depreciation is deducted from gross income in computing taxable income, the greater the value of the depreciation deductions, the greater the project's expected rate of return. And of course, the less a project costs, the higher will be its expected rate of return.

If tax rates are raised, they will reduce returns on investment by cutting after-tax profits. Similarly, stretched-out write-off periods and nonaccelerated depreciation methods decrease expected rates of return by decreasing the value of depreciation deductions.

The corporate income tax encourages investment in projects that use relatively more depreciable capital and relatively less labor and nondepreciable capital. It also encourages investment in short-term depreciable assets—particularly equipment—while discouraging investment in long-term depreciable assets, especially structures. In general, the corporate income tax probably reduces the amount of investment undertaken by all businesses because the double taxation of corporate income (once when earned by business and once when earned by shareholders in the form of dividends) leads to a reallocation of capital and labor that reduces the after-tax profitability of all capital and, therefore, reduces the flow of funds to business.

Use of Debt Encouraged

The corporate tax also encourages the use of debt as a means of raising money instead of equity. This is because interest expenses can be deducted from pretax corporate income, whereas dividends can not. Indeed, as debt is substituted for equity, corporate shareholders receive the tax saving that results from interest expenses lowering taxable income, thus corporate income taxes. Of course, financing investment by use of debt rather than equity affects the cost of capital against which investment projects' expected rates of return will be compared.

Because the uneven tax treatment of dividends versus interest makes it more expensive to raise capital by equity than by debt, some people believe that the more investment projects funded by debt, the lower the cost of capital and the greater the number of projects that will meet the minimum return on investment criterion. They have used this fact to argue that the corporate income tax has little effect on total investment. But it is not quite so simple. Financial experts discourage large amounts of debt financing by corporations. Too much use of debt compared with equity increases leverage and could lead to defaults on interest and principal payments, and bankruptcies in periods of recession and/or rising interest rates.

Turning to the impact on our balance of payments, when the international monetary system consisted of fixed exchange rates, it was contended that a lower corporate income tax, combined with a value-added tax that would be rebated on exports, would tend to discourage the

outflow of capital from the United States. The resulting greater availability of funds would lead to greater investments, improved productivity and an enhanced competitive position of U.S. industry, thus helping the balance of payments. However, in today's regime of floating exchange rates, changes in corporate taxes would have little effect on the competitiveness of goods manufactured by U.S. companies, or the United States' attractiveness as a place to invest. While lower taxes might attract capital to the U.S., this would raise the value of the dollar, thereby cutting our competitiveness in world markets.

In view of the importance of corporate profits on the one hand, and the distorting impact that the corporate income tax has on investments and methods of financing on the other, you would think that the Treasury's tax reform proposals would keep these pluses in mind while addressing the minuses. Although the Treasury does propose to reduce the corporate tax rate from a maximum of 46 percent to 33 percent, it also proposes to do away with the Accelerated Cost Recovery System and the investment tax credit. The net outcome would seem to be an increase in the cost of capital, a decrease in corporate liquidity and a decrease in capital investment. Over the ten years 1984–1994, there could well be a jump of over 30 percent in corporate tax revenues as a result of this change.

The Treasury's Motives

In making this decision to go after the goose that lays the golden egg, the Treasury must have concluded either that big budget deficits are here to stay, thus more room must be made for the government to finance them, or that the only way that these deficits can be brought down would be through revenue enhancements, as opposed to spending cuts, because the proposals for tax reform clearly aim in both directions.

For one thing, by substituting the Real Cost Recovery System for the Accelerated Cost Recovery System and by eliminating the investment tax credit, the Treasury will raise the cost of capital formation. Because of this increase in the cost of capital, business will have an increased incentive to substitute labor for capital. In turn, the fall in the capital-labor ratio will result in substantially less productivity growth for the American economy. Less productivity growth and higher rates of employment will cause the rate of inflation to go up. The higher rate of inflation will boost nominal GNP and both individual and corporate tax revenues, although there would be some offset from the indexing provisions at both the individual and corporate levels. There won't be that much of an offset, however, since the Treasury's proposal would raise roughly $165 billion more than the present law over the period 1984–1994, according to an analysis by the Wharton Econometric Model.

Since raising the cost of capital will depress corporate investment, it is likely that there will be less corporate borrowing. This alone will tend to make room for the government to raise money to finance its deficit. And if Washington does manage to increase its tax take thus cutting its borrowing needs, then lower interest rates could result. The immediate effect of lower interest rates would be to further help the government's budget position, although it might also make some marginal investment projects more viable.

One point should be noted before closing. The Federal tax burden on corporations is not as low as it seems. It may be true that the corporate income tax accounted for only nine percent of Federal tax receipts last year compared with 17 percent in 1970 and 29 percent in 1950. However, it should also be noted that corporate profits are a much smaller part of the economy today than they once were. Corporate income as a share of GNP in 1984 was only six percent compared with 14 percent in 1950. Little wonder that a tax on corporate income accounts for a smaller portion of total Federal revenues.

Looked at another way, corporations actually pay a very high percentage of their income to the Federal government—a much higher percentage than most individuals pay. According to the Commerce Department, corporations pay about 50 percent of their income to the Federal government. at least half of that due to the corporate income tax alone. By contrast, individuals pay an average of ten percent of their personal incomes in the form of income taxes.

In conclusion, it seems to me that corporate profits and the corporate income tax remain the favorite whipping boy of the politicians, reformers, and so on. Whether in the name of "equity" or simply as a hidden means of raising revenues, corporate profits seem likely to be subject to higher taxes. But before this occurs, we should keep in mind that this would slow economic growth, lessen productivity gains, increase the rate of inflation, and decrease our standard of living. It could also make business even more dependent on borrowed funds than it already is, thus more susceptible to changes in the economic and financial climate.

Whatever the government might accomplish in the short run, it would be at the expense of greater economic instability, longer-term. H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

JUNE 1985

Business Conditions Update

In the past few months, the word "recession" has cropped up with disturbing frequency in discussions regarding the business outlook. Because the last recession ended some 2-1/2 years ago, and because peacetime business upswings have lasted less than three years, on average, you can see why many people are nervous. It would appear that those who have been raising the specter of recession have good reason to do so. The recent spate of economic statistics has not painted a very bright picture. Indeed, negative numbers are becoming more common, thus more worrisome.

I don't wish to suggest that I am oblivious to bad news. However, a close scrutiny of all the economic statistics suggests that reports of this expansion's imminent demise—like those of Mark Twain's death—have been greatly exaggerated. There are quite a few pluses in the economic picture that are sustaining growth. Meanwhile, the conditions that normally precede the onset of a full-blown recession do not appear to be on the scene today. Accordingly, it is reasonable to expect that the gross national product adjusted for inflation, after rising faster in the second quarter than in the first according to the Government's "flash" estimate, may well advance at an even speedier clip during the third and fourth quarters of this year (see table inside).

Faster Growth Has Returned...

Let's look at the most recent calendar quarter first. You may recall that the February Economic Report suggested that it is necessary to take into account the influence of foreign trade in forecasting the gross national product nowadays because of the size of the trade deficit. The chief reason why the real GNP grew so slowly in the first quarter was a dramatic widening in the trade deficit compared with the fourth quarter. It was observed at that time that faster growth would be possible in the second quarter if the trade deficit did not worsen materially. This seems to have happened: The nine percent decline in the trade-weighted value of the dollar since February evidently was enough to keep the GNP version of the trade deficit, adjusted for inflation, from deteriorating much further.

On the positive side, let's examine two industries that are still exhibiting a fair amount of strength. Both domestic new-car sales and residential construction are still holding up. So far this year, Detroit is selling automobiles at an 8½ million unit annual rate. This is 15 percent above the average rate six months earlier—and almost two-thirds higher than the levels of three years ago. And even though the quotas on Japanese imports were recently lifted, Detroit's prognosis still looks good. For one thing, the Japanese are likely to move slowly and not flood the U.S. with their autos, figuring that if they do, these quotas might be reinstated. For another, Detroit seems to have found the right combination of style, size, and price to appeal to a growing number of buyers. The special interest rate financing packages that have been offered on a number of models seem to have helped, too.

...Thanks to More Consumer Spending...

For their part, housing starts are still strong—notwithstanding May's decline. New home construction has climbed by nearly 20 percent in the past six months. It's not hard to see why: Mortgage interest rates have tumbled 1½ points since 1983, bringing housing within the range of affordability of a growing percentage of U.S. families. Three years ago, when mortgage rates topped 18 percent, all but 15 percent of U.S. households were precluded from buying a home. The percentage who could afford to buy was the smallest in the postwar era and it showed up in the rate of new home construction, which at 855,000 in early 1982, was the lowest since the end of the second World War. Now that fixed mortgage

NO REPORTS IN SUMMER

The Economic Report will not be published during July and August. The next issue will appear in September.

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rates are down to 12 percent, some 40 percent of U.S. households can afford to buy a house. The last time this high a percentage could afford to buy a house, 1978, the rate of new home construction topped two million units.

Although there is a belief that the U.S. economy is shifting from manufacturing to services, the fact remains that so many industries benefit from the production of autos and housing that it would be difficult—if not impossible—for the U.S. economy to slide into recession while these two major industries are strong. And they are likely to remain healthy, since the consumer still seems to be in good shape. For one thing, there are almost a record number of people holding jobs. Total employment in May was nearly 107 million people. Meanwhile, nonfarm payrolls over the past year grew by 3½ million—not far below the 4½ million rise recorded in the previous 12 months.

This has occurred despite flatness in the manufacturing sector. Factory payrolls have changed little over the past year. By contrast, employment in service industries jumped by nearly three million over this time. More jobs, of course, mean more incomes, and with taxes and inflation down, buying power continues to expand. Along with a savings rate that seems to be back to normal, this should ensure continued gains in consumer spending in the months ahead. And while use of credit is up, so is wealth: People now own $2.21 of financial assets for each dollar of debt outstanding, ten percent more than the early 1980 low point.

...And A Decline in Interest Rates

Another factor that should be taken into consideration in assessing current business conditions as well as the outlook is the level of interest rates. Short-term interest rates are now at their lowest levels in at least seven years, while long rates are at five-year lows. And while this has reduced the growth in personal interest incomes somewhat, it has also lowered the cost of borrowing to buy houses, cars, or other big-ticket items for consumers—not to mention inventories, plants and equipment for business. Needless to say, the Federal Government is benefiting as well. Each percentage point increase in interest rates eventually costs Washington nearly $10 billion a year in interest on the national debt. The 3½-point drop in interest rates on Government securities since last summer has clearly saved Washington quite a lot of money in interest costs.

Credit the Federal Reserve for this favorable development. While the Fed tightened early in this expansion (May 1983) to avoid a resurgence of inflation, it loosened quickly (August 1984) to avoid a recession. I would expect the Federal Reserve to maintain this accommodative monetary posture until either GNP growth or inflation picks up substantially. I would not expect much additional ease on the part of the Fed since this might cause the money supply to grow so rapidly that it would reawaken inflation and the expectation of inflation. Furthermore, it might not be of much help in today's rather different economic circumstances.

As I have noted in the past (Economic Report—December 1984), the chief reason for our sluggish economic performance since last summer seems to be the rise in the value of the dollar in foreign exchange markets and its impact on the ability of U.S. companies to sell goods abroad and/or compete with imported merchandise. In this connection, lower interest rates might not only not depress the value of the dollar—they could even strengthen it, since the foreign exchange markets might conclude that lower interest rates would be a prelude to faster economic growth, hence better investment opportunities than exist abroad.

On the other hand, it would seem as though the Fed would not like to see a recession develop, either. For a number of key industries, regions, and nations have yet to recover from the last bout of recession and high interest rates. The strong dollar has caused increased competition, which has prevented many companies from raising selling prices—even in the face of rising costs—thus putting pressure on profits and margins. To close the gap between internally-generated funds and capital outlays, many companies were forced to tap external sources for funds, and because interest payments are tax deductible but dividends are not, most of these funds were borrowed, thus causing balance sheets to become highly leveraged. The country debt situation needs little elaboration. Many debtor nations depend on the United States to buy their exports, which they must sell in excess of what they import to earn enough money to service their debts. A recession here would clearly put the kibosh on developing country improvement.

Another reason for the Fed wanting to avoid a recession is that it would widen Washington's budget deficit. Since the Government's budget deficit is too big now, fiscal policy would appear to be unavailable to help fight a possible recession, leaving the entire burden on monetary policy. Those who remember their economic theory will recall the phrase "liquidity trap." John Maynard Keynes discussed this in analyzing the Depression of the 1930s, when no amount of monetary ease could seemingly get the economy moving. This led him to recommend the use of fiscal policy (deficit spending) as the Government's chief anti-slump tool. But if fiscal policy is inoperative, and monetary policy is not effective, then the next recession could turn out to be quite an experience.

June, 1985

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	1984				YEAR 1984		< Actual		Projected > 1985		YEAR 1985	
	1	2	3	4	LEVEL	% CH	1	2*	3	4	LEVEL	% CH
Gross National Product	3553.3	3644.7	3694.6	[illegible]	3662.8	10.8	3810.6	3870.2	3932.8	4003.2	3904.2	6.6
GNP: $72	1610.9	1638.8	1645.2	1662.4	1639.3	6.8	1663.5	1676.2	1691.6	1707.1	1684.6	2.8
% Change, Annual Rates	10.1	7.1	1.6	4.3	6.8		0.3	3.1	3.7	3.7	2.8	
Consumption	2276.5	2332.7	2361.4	2396.5	2341.8	8.6	2446.5	2496.1	2539.1	2585.2	2516.7	7.5
Durables	310.9	320.7	317.2	326.3	318.8	13.9	334.8	344.1	359.6	369.4	352.0	10.4
Non-Durables	841.3	858.3	861.4	866.5	856.9	6.9	877.3	890.7	901.9	913.3	895.8	4.5
Services	1124.4	1153.7	1182.8	1203.8	1166.1	8.5	1234.4	1261.3	1277.7	1302.5	1269.0	8.8
Investment	623.8	627.0	662.8	637.8	637.9	35.2	646.8	656.6	671.3	687.3	665.5	4.3
Non-Residential	398.8	420.8	435.7	447.7	425.7	20.6	450.9	463.7	468.1	475.6	464.6	9.1
Producers Durable Equipment	256.7	270.7	284.2	289.7	275.3	23.4	288.0	294.8	297.8	304.6	296.3	7.6
Structures	142.2	150.0	151.4	157.9	150.4	16.0	162.9	168.8	170.2	171.0	168.2	12.3
Residential	151.2	155.6	155.3	153.5	153.9	16.4	155.2	160.8	170.1	177.3	165.9	7.8
Inventory Changes	73.8	50.6	71.8	36.6	58.2		40.7	32.1	33.2	34.4	35.1	
Net Exports	−51.5	−58.7	−90.6	−56.0	−64.2		−74.5	−83.6	−90.5	−95.1	−85.9	
Government Purchases	704.4	743.7	761.0	780.5	747.4	9.0	791.9	801.1	812.9	825.8	807.9	8.1
Federal Defense	213.4	220.8	220.3	231.6	221.5	10.5	233.9	240.7	245.2	250.5	242.6	9.5
Federal Civilian	54.2	75.5	81.7	84.1	73.9	6.7	85.9	85.8	86.6	85.6	86.0	16.3
State & Local	436.8	447.4	458.9	464.8	452.0	8.7	472.0	474.6	481.0	489.7	479.3	6.0
Final Sales: $72	1579.3	1618.5	1614.6	1645.6	1614.5	5.0	1644.4	1661.0	1676.7	1692.5	1668.7	3.4
% Change, Annual Rates	3.6	10.3	−1.0	7.9	5.0		−0.3	4.1	3.8	3.8	3.4	
Domestic Demand: $72	1619.2	1650.2	1672.2	1675.8	1654.4	8.7	1691.9	1704.5	1717.4	1730.2	1711.0	3.4
% Change, Annual Rates	12.9	7.9	5.4	0.9	6.7		3.9	3.0	3.1	3.0	3.4	
GNP Price Index (1972 = 100)	220.6	222.4	224.6	226.1	223.4	3.6	229.1	230.9	232.5	234.5	231.8	3.7
% Change, Annual Rates	4.4	3.3	4.0	2.8	3.8		5.4	3.2	2.8	3.5	3.7	
Consumer Price Index (1967 = 100)	306.9	309.7	312.5	315.3	311.1	4.3	317.8	321.2	324.3	327.7	322.7	3.7
% Change, Annual Rates	5.3	3.7	3.7	3.5	4.3		3.3	4.3	3.9	4.2	3.7	
Total Personal Income	2920.5	2984.5	3047.2	3096.2	3012.1	9.8	3141.1	3194.8	3242.2	3299.2	3219.3	6.9
Disposable Personal Income	2502.2	2554.3	2606.4	2644.5	2576.8	10.1	2653.4	2744.6	2762.6	2809.1	2742.4	6.4
Savings Rate	6.1	5.7	6.3	6.2	6.1		4.5	5.7	4.7	4.6	4.9	
Employment Rate	57.5	58.0	58.0	58.2	57.9		58.5	58.6	58.7	58.8	58.6	
Unemployment Rate	7.9	7.5	7.5	7.2	7.5		7.3	7.4	7.4	7.4	7.4	
Indus. Production (1967 = 100)	159.8	163.1	165.6	164.7	163.3	10.7	165.4	164.6	167.0	169.7	166.7	2.1
Housing Starts (000)	1947.0	1857.7	1663.0	1598.0	1766.4	3.8	1793.0	1858.3	1885.6	1944.3	1870.3	5.9
Domestic Auto Sales (000)	8103.0	8163.3	7897.7	7964.0	7957.0	17.1	8454.7	8308.3	8294.9	8310.5	8342.1	4.8
Corporate Pre-Tax Profits	243.3	246.0	224.8	228.7	235.7	16.0	222.3	208.4	215.2	223.0	217.2	−7.8
−Taxes	92.7	95.8	83.1	87.7	89.8		85.3	74.3	77.7	81.3	79.7	
Net Profits	150.6	150.2	141.7	141.0	145.9	14.5	137.0	134.1	137.5	141.7	137.6	−5.7
−Dividend Payments	77.7	79.9	81.3	83.1	80.5	10.5	84.5	85.0	86.9	89.1	86.4	7.3
Undistributed Profits	72.9	70.2	60.3	58.0	65.4	19.9	52.5	49.1	50.6	52.5	51.2	−21.8
+Depreciation	287.5	296.4	306.4	317.3	301.9		326.5	336.9	346.7	357.5	341.9	
−Inventory Profits	13.5	7.3	0.2	1.8	5.6		−0.9	5.0	10.0	15.6	7.4	
Net Cash Flow	346.9	359.3	366.5	373.7	361.6	17.5	379.9	381.1	387.4	394.4	385.7	6.7

The Absence of Pre-Recession Conditions...

Another reason for optimism regarding the balance of 1985 stems from the absence of conditions that usually appear just prior to a recession. These usually take the form of excesses of one type or another. For example, although employment is up, unemployment remains high. This suggests that for most industries there are potential workers who can be tapped to expand output, thereby minimizing the threat that shortages could slow down the economy. The same may be said for utilization of capacity. In contrast to this point in previous postwar expansions, the capacity utilization rate in the important manufacturing sector is barely above 80 percent. Two-and-a half years into the other recoveries that lasted this long found the utilization rate an average of four points higher, and the threat of shortages and bottlenecks that much greater.

Inventory policies are cautious. This means that business is unlikely to decide suddenly to cut back because of excessive amounts of unsold goods, as happened a year ago, when many sectors built inventories at a rapid pace. It seems that retailers were experiencing booming sales and expected this trend to continue. Those industries that serve the capital goods business, after examining surveys of business spending intentions which showed that a substantial rise in capital spending was in the offing, also built up stocks to prepare for this increase in demand. Elsewhere, there were those who believed

that inflation would worsen, thus making it worthwhile to build stockpiles before their prices rose substantially.

These expectations, by and large, were not fulfilled. After spending heavily in 1983 and early 1984, the consumer cut back by the middle of last year, leaving many retailers saturated with unsold merchandise. And while business capital spending, adjusted for inflation, did rise at the fastest clip in 20 years as the surveys suggested, the strength of the dollar caused a good part of this growth in demand to be channeled abroad. Thus many capital goods manufacturers were disappointed in their sales volume and they, too, had to cut back. And inflation not only did not flare up (Economic Report—March 1984), it slowed down, with price declines common in many wholesale markets in the last few months of 1984.

As a consequence, the U.S. economy underwent a mini-inventory correction. From an annual rate of $31 billion (real terms) in third-quarter 1984, stockbuilding slowed to about half that pace by second-quarter 1985, trimming more than one point from economic growth over this period. Had the rate of stockbuilding in second-quarter 1985 remained at third-quarter 1984's rate, the real gross national product would have grown by nearly three percent during these three quarters, instead of 1¾ percent.

Such an inventory correction is unlikely to impact the economic scene, near term. Retailers and capital goods industries, having learned their lessons, are extremely cautious and are watching inventories carefully. And few if any economists are expecting a significant flareup in inflation for the simple reason that the factors that have kept inflation down over the past year or two remain in place today. Indeed, it looks like 1985 will be the fourth year in a row in which consumer prices rise by four percent or less. You have to go back to 1967 to match this performance!

...Clears the Way for Continued Expansion

I hope this reasoning and analysis is reassuring insofar as the near-term outlook is concerned. Even though the important manufacturing sector has been flat on its back for more than a year now, the rest of the economy still seems to have enough vigor to keep the overall GNP on the rise, thus avoiding a recession. But this is no reason for policymakers to relax. Indeed, decisions made in Washington this year will have a significant impact on the outlook for business in 1986 and beyond.

In this connection, the timing of the President's tax reform program is most unfortunate. Notwithstanding the benefits it might confer on some individuals, industries and regions, it is likely to distract the Congress from dealing with the number one agenda item—reducing the budget deficit. Since cutting the deficit involves inflicting pain, whether by decreasing spending or increasing revenues, such a course of action is unlikely to be considered in 1986, when the entire House of Representatives and one-third of the Senate are up for election. If any politician had the notion that he or she could run for office successfully on such a belt-tightening program, the experience of 1984's Democratic candidate for President, who promised to raise taxes if elected and wound up carrying only his home state, should dissuade them, without a doubt. And if nothing is done in 1986 to reduce the budget deficit, it will be even harder to tackle the problem in 1987 when both parties will be posturing for the 1988 Presidential race.

Thus, no action this year promises literally four more years of mammoth budget deficits. If this occurs, the Government's annual interest cost, by its own calculations, will soon reach the size of this year's budget deficit. If and as that happens, all bets are off regarding recessions, double-digit inflation, or both. H

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Economic Report

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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SEPTEMBER 1985

Crowding Out

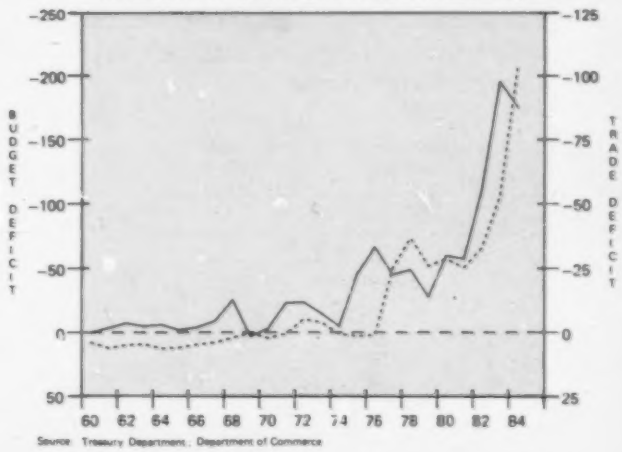
Superficially, it would appear as though the U.S. economy has dodged another bullet. After more than a year of sluggishness, several of the key indicators of business activity have begun to strengthen. Preliminary data for August indicate that the unemployment rate has broken out of its half-year range and has fallen to its lowest level since April, 1980, while employment reached a new record high. This obviously bodes well for personal incomes, providing consumers with increased buying power during the important back-to-school and fall shopping seasons. And if retail sales climb, output should not be far behind, since inventories have been sweated down in most lines of business, while the decline in the value of the dollar from its February peak suggests that domestic producers will share in some of this increased demand.

From a longer term perspective, comparisons appear even brighter. At the beginning of this decade, labor productivity was falling as the rate of inflation moved into the double-digit range. Likewise, most interest rates were in double-digit territory—some reaching record highs. Today, productivity is growing on the strength of renewed investment by business in plants and equipment, while inflation has slowed dramatically to less than four percent at the consumer level and below one percent at the producer or wholesale level. For their part, interest rates have fallen significantly, although not as much as inflation has receded.

Washington's Financing Needs...

Does this mean that we should sit back and anticipate another era of good economic times? Not necessarily. This is because we are left with a legacy of the economic policies that produced these seemingly favorable developments—a massive deficit in Washington's budget. Initially a stimulus to economic activity, the deficit has now become a drag, crowding out more and more of the private sector as the weeks and months go by. Yet because it is not impacting business in the conventional sense, some economists and a few politicians would have you believe that the budget deficit is not the ogre it obviously is.

CHART I
FEDERAL BUDGET DEFICIT (LINE) VS. MERCHANDISE TRADE DEFICIT (DOT) <BILLIONS OF DOLLARS>



Source: Treasury Department, Department of Commerce

To be sure, a cursory glance at the financial markets reveals little evidence of crowding out. As noted above, interest rates are down significantly from their recent peaks both in nominal and in real terms. In addition, money is plentiful for those who wish to borrow, since there are virtually no restrictions that prevent banks from gathering deposits and charging market rates of interest on loans. However, even here all is not entirely copesetic. For one thing, real interest rates (nominal interest rates minus the rate of inflation), while down from their peaks of several years ago, are still much higher than they were on average during most of the 1970s, not to mention the 1960s and the 1950s. This has inhibited those industries which are dependent on the availability of low-cost credit such as housing and automobiles, while making it difficult for many small and medium-sized businesses to stay alive. This year we will build at least 500,000 fewer housing units than we did more than a dozen years ago, when the age group that buys the most homes—the 25-34 year olds—was half the size it is today. And if Detroit produces eight million cars this year, it will still fall short of 1973's level by 1¾ million units.

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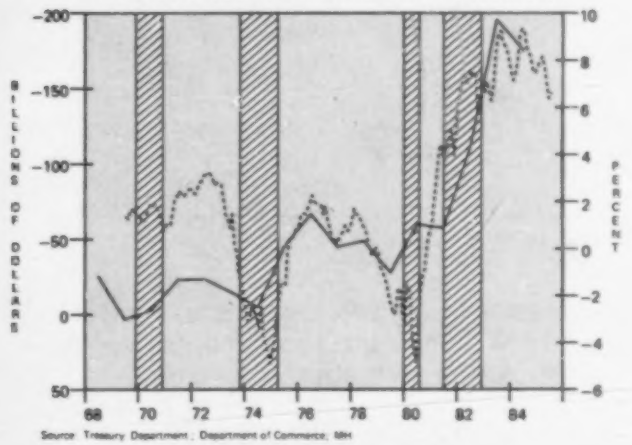
But the budget deficit is crowding more than just housing and autos. It is crowding virtually the entire goods-producing sector of the U.S. economy— not by pulling money away directly, but by creating conditions such that this sector doesn't need to borrow the funds. I speak of another legacy of the economic policies of the past few years—our trade deficit. Chart I shows that there is an unmistakable relationship between the budget deficit and the trade deficit. As the budget deficit moved out of its historical range to record levels, so did the U.S. deficit on merchandise trade. Imports speeded up while exports fell, depressing activity in the goods-producing sector of the economy. Those industries that export found markets for their products diminished overseas so they cut back production, while those industries which compete with goods produced from abroad also found they had to slash output, because more merchandise was entering the U.S. than before. In both cases, less production meant halted assembly lines, closed factories, lost jobs—and less need for funds.

CHART II
FEDERAL BUDGET DEFICIT (LINE) VS. REAL INTEREST RATE ON 7-YEAR TREASURY NOTES (DOT)



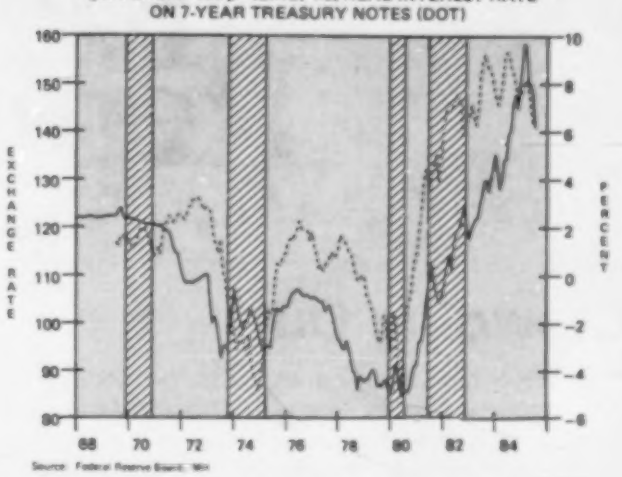
Source: Treasury Department, Department of Commerce, MH

It is not too difficult to determine the linkage between the budget deficit and the trade deficit. Chart II shows that the budget deficit caused real interest rates to rise out of their historical boundaries. These interest rates rose in response to the pressures on the financial markets that Washington's budget deficits represent. Since the financial markets are free of controls, and since Washington gets first crack at the availability of funds, interest rates are the means by which money is rationed. Washington is obviously not sensitive to the cost of borrowing money the way the private sector is; it borrows what it wants when it wants to with little regard for cost.

...Reach Overseas...

As high as these interest rates went, they would have been higher had the U.S. financial markets been closed to funds from abroad. As it is, these high interest rates attracted money from other countries, searching for a

CHART III
U.S. DOLLAR TRADE-WEIGHTED EXCHANGE RATE <MAR. 1973=100> (LINE) VS. REAL INTEREST RATE ON 7-YEAR TREASURY NOTES (DOT)



Source: Federal Reserve Board, MH

higher rate of return. In order to take advantage of these rates, holders of other currencies had to convert them into dollars. Thus, the dollar rose in value compared with the currencies of its major trading partners, a development that closely parallels the jump in real interest rates as can be seen in Chart III.

Of course, a change in the value of the dollar will affect our terms of trade. As the dollar climbed in value from its low in the middle of 1980, goods produced in the United States intended for sale abroad became more expensive to the holders of other currencies against which the dollar was rising. This prompted foreign consumers to either import fewer wares from the U.S. and/or shift their purchases to other countries where prices were more stable. Plainly, this led to a drop in exports from the U.S. At the same time, articles produced overseas became cheaper when sold in the U.S. because they were priced in currencies which were falling in value compared with the dollar. The end result, as Chart IV indicates, was a rise in the trade deficit in tandem with the rise in the value of the dollar.

A look at the financial side now will reveal more clearly the process by which Washington is crowding out the private sector. First, we should note that the U.S. borrows more than it saves. This is because the personal savings rate in the U.S. is relatively low while private and public demands for funds are comparatively large. While it may be true that the Federal Reserve has increased the supply of money and credit at a rather hefty pace over the past few years, it also true that the combination of borrowing by consumers, business, and Washington has expanded rapidly, too. As a consequence, the U.S. has been forced to borrow from foreign capital markets (see table).

As it turns out, these funds were available to be tapped by

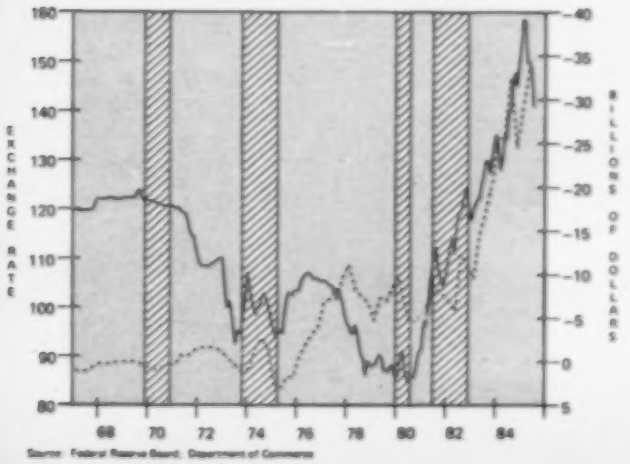
the U.S. because of two reasons: there were surplus funds and they were attracted to the U.S. by our high interest rates.

As far as the general public is concerned, these developments have been greeted with mixed reactions. Those whose jobs are secure and whose incomes have been growing have benefited from the strong dollar by being able to choose from a wider variety of products at relatively stable prices. On the other hand, those who work for companies less able to export and/or compete with imports have found their jobs less secure, thus are less sanguine about the current situation. Indeed, along with the managements of those companies and industries affected by our trade deficit, these workers are now pressuring their congressmen to do something to restrict the inflow of foreign-made goods and open up markets to U.S. exports.

...Causing A Massive Trade Deficit...

While there is a certain element of truth in the arguments made by many domestic companies regarding the subsidies that foreign governments give their exporters and the barriers they have erected to the entry of goods from the U.S. (and other countries), neither of these developments is especially new. What is new is the extent to which we are running this imbalance in our foreign trade and the harm it is doing to the U.S. economy. One can sympathize with the pleas for protection by those industries which have been affected by our trade deficit. However, attacking the symptom of our difficulties (the trade deficit), and not their cause (the Federal budget deficit), will probably create more problems than it solves. For one thing, any effort to cut the flow of imports by quotas or tariffs runs the risk of retaliation by others which will affect our exports. For another, there are some imports that are vital to our domestic activity such as components for

CHART IV
U.S. DOLLAR TRADE-WEIGHTED EXCHANGE RATE <MAR. 1973=100> (LINE) VS. MERCHANDISE TRADE DEFICIT, BOP BASIS (DOT)



Source: Federal Reserve Board, Department of Commerce

DOMESTIC INVESTMENT GAP
VS. FOREIGN CAPITAL INFLOWS
(billions of dollars; selected fiscal years)

Fiscal Year	Gross Savings[1]	Gross Investment[2]	Difference	U.S. Budget Deficit	Foreign Capital Inflows[3]
1980	$403	$403	$0	$60	-$2
1981	466	467	-1	57	-6
1982	445	441	4	111	8
1983	402	431	-29	195	41
1984	534	631	-79	175	102
1985*	555	646	-91	210	140

1) Gross savings equals the sum of gross private savings (corporate and household) and state and local government surpluses and capital grants received by the U.S.
2) Gross investment equals gross private domestic investment.
3) Current account balance, sign reversed (calendar years).
*Estimate
Source: Bureau of Economic Analysis; Treasury Department; MH

U.S.-made goods. There are others, such as videotape recorders, pocket calculators and Walkman-type portable radios that aren't even made in the U.S. which could also be affected.

But there is another, potentially more significant consequence that would arise from a sudden reduction in our trade deficit. If our trade deficit were to decline, other countries' trade surpluses would be similarly cut. In and of itself, this is fine—except that such action will reduce the funds that foreigners have available for investment in U.S. financial assets. Even this would be all right were it not for Washington's huge borrowing requirements associated with its budget deficit. Cutting off the inflow of foreign funds without reducing Washington's need for funds would lead to either sharply higher interest rates, if the Federal Reserve does not replace these funds by pumping up the money supply, a step-up in the rate of inflation if the Fed does—or both. What is more, the potential dollar scarcity that could result if protectionist legislation cuts the flow of imports could very well boost the dollar's value further, thereby squeezing our industrial sector even more.

...And Calls For Protection

Instead of pressuring Congress to enact protectionist legislation, businessmen and workers who have been adversely affected by our trade deficit should, instead, urge their elected representatives to agree with the President on a means of reducing our domestic budget deficit. One way or another, Washington's deficit will be financed; if not from funds that come from abroad, then from funds currently in the United States. If this latter situation develops and the Federal Reserve does not expand the money supply faster, then the indirect crowding out process that has been affecting mainly the goods-producing sector of the economy will become a direct crowding out phenomenon—depressing enough of the U.S. economy to plunge it into another recession.

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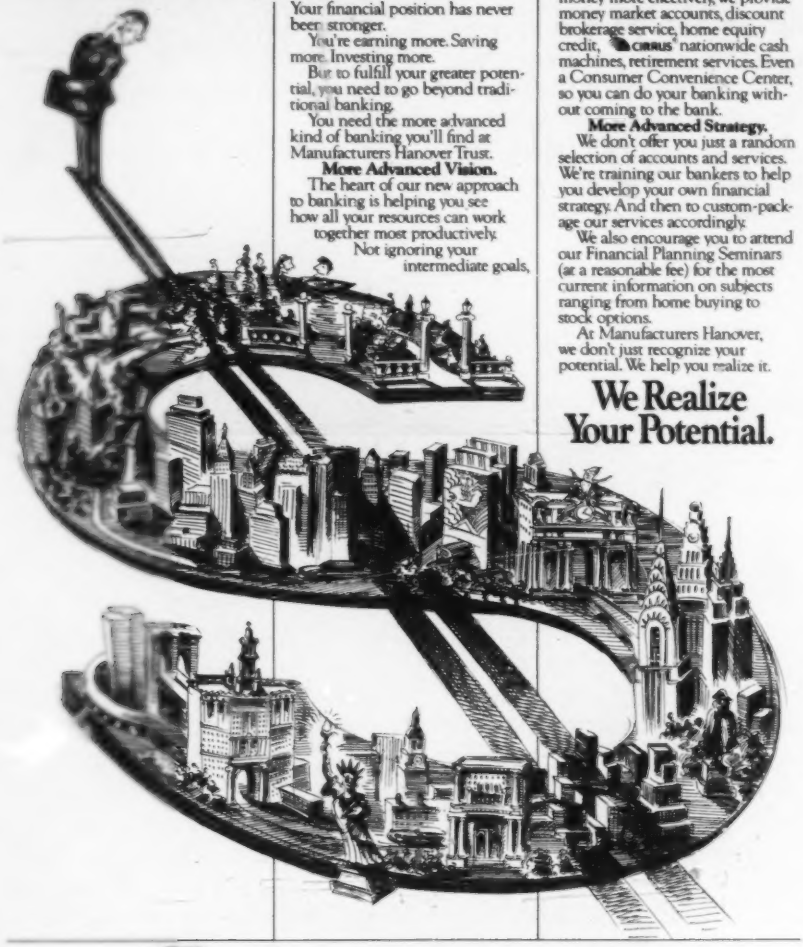

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

OCTOBER 1985

Economic Forecast For 1986

There is good news and bad news on the economic scene. The good news is that the near-term business outlook is much brighter than most economists and businessmen now anticipate. Not only is there no recession in sight, but the rate of economic growth is poised for a significant pickup—with virtually all sectors of the U.S. economy joining in before long. The bad news is that unless there is meaningful progress in reducing Washington's budget deficit, this rebound in economic activity will bring with it a revival of inflation. While this development in particular may not be unwelcome in some quarters (Economic Report—January 1985), it will ultimately lay the groundwork for an end to the current business expansion—albeit not for several years.

Call it a mini-recession, stagnation, or simply selected sluggishness, there is no doubt that the U.S. economy just had a close call. After expanding at an annual rate of about 6¼ percent during the first two years of this business expansion, the gross national product adjusted for inflation barely budged at all during first-half 1985. The real GNP at midyear was only half of one percent greater than it was at yearend 1984. Not surprisingly, the unemployment rate flattened during the first half of 1985, following a drop of nearly four percentage points during the previous two years. Notwithstanding the low rate of inflation and the Federal Reserve's willingness to accommodate the demands for funds in the economy by letting the money supply grow rapidly so that interest rates might decline, a number of economists and businessmen began to anticipate another recession.

A Change For The Better

However, over the summer a change seems to have taken place. Overall business activity as measured by the real GNP is reported to have grown by an annual rate of nearly 3½ percent during the third quarter. Coming in the context of a slight widening of the trade deficit and outright liquidation of business inventories—both of which represent a subtraction from the real GNP—this increase is more significant than it looks. As the table inside indicates, final sales (GNP less the change in business inventories) grew at a 5.9 percent clip in the third quarter after rising at a two percent annual rate in the first half of 1985.

Looking further into the third quarter's figures provides additional reasons for optimism. The consumer was a major factor contributing to the third quarter's pickup. This is not unusual, since personal consumption expenditures bulk so large in the GNP data, accounting for about two-thirds of the overall economy. The fact that a large part of the rise traced to a surge in auto sales has led some people to think that the consumer is going to cut back in the months ahead. There is a general impression that the consumer is tapped out. The savings rate is down to a 35-year low, while use of credit appears to be at a record high.

The Consumer Is Alive And Well

From here, it would appear that the consumer sector has quite a bit of life left in it. For one thing, the surge in sales of the 1985s has put a lot of new cars on the road and serves as a constant reminder to those who haven't bought a new car in recent years (the average age of cars on the road is 7½ years old—the oldest in at least 35 years) how new and different recent models can be. For another, several dramatically restyled offerings are scheduled to appear in the months ahead which should also give a lift to sales. And of course, one should not overlook the fact that interest rate incentives still exist.

To be sure, if the consumer is indeed tapped out, then he will not be able to buy new cars or other big-ticket items, no matter how attractive physically, technologically, or financially, they may be. Accordingly, it is necessary to look at the state of consumer finances to see just exactly what shape people are in. Besides the low savings rate

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noted above, those who have expressed concern about the state of the consumer refer to the apparent rise in household indebtedness. Last year consumer installment credit jumped by 20 percent, the highest annual increase since 1955. Compared with take-home pay, consumer installment credit now equals almost 19 percent—a record. What is more, people must now set aside 3½ percent of their after-tax incomes just to pay the interest on this debt compared with less than 2½ percent, on average, during the 1970s.

However, if one looks beneath the surface, one can be more sanguine. A recent study sponsored by the Federal Reserve Board and conducted by the Survey Research Center of the University of Michigan suggests that debt burdens are not as great as they seem. For one thing, it appears that almost half of the installment credit outstanding is owed by households in the highest income quintile. This proportion is a substantial increase from 1977, when the richest households held about 36 percent of such credit, and from 1970, when they accounted for only 22 percent.

Thus it is fairly evident that much of the recent rise in debt has been accumulated by those high income households which are probably best able to service it, if not take on more. The Fed study estimates that nearly three-quarters of the households in the highest income bracket, as well as the next highest, utilize installment debt. By contrast, less than one-third of the households in the lowest income bracket are in debt today; they account for less than five percent of total consumer credit outstanding.

Another factor influencing the growth of consumer credit has been the expanding use of credit cards. The way these figures are put together, use of credit cards adds to consumer debt, as might be expected. However, the Fed notes that credit cards are being used increasingly for convenience, rather than for borrowing. The Fed believes that approximately half of the card-using public pays credit card bills in full within the billing period, and that if such convenience use is netted out, the ratio of debt to income would be about one percentage point lower than it is.

Looking at autos in particular, it should be noted that maturities are lengthening. When the Fed calculates installment credit outstanding, it includes the principal amount plus all future interest payments on any loan that has a definite maturity date. While this definition has been consistent over time, the impact on measured debt outstanding can be quite misleading if the average maturity of the debt has increased—which it has, from three to over four years.

Another factor that must be taken into account when assessing the consumer's ability to handle debt is demographics. The movement of the baby boom generation into the age groups that tend to use debt most heavily has added to the growth of consumer credit. The 25-44 age group currently represents about 30 percent of the population but holds nearly 60 percent of the debt outstanding. These folks have always been disproportionate users of debt, since they are in the age brackets where consumption is the highest as families are formed, homes are purchased and furnished, etc. Thus, while their intensive use of debt is nothing new, the fact that this group is growing rapidly clearly adds to overall debt usage.

This factor is also aiding the housing market. New-home sales have exceeded 700,000 per month for the last three months. The last time this happened was in the summer of 1979. The percentage of households that can afford to buy a home has bounced up significantly from its 1982 lows and is now nearly 40 percent. This suggests that new-home construction, which has been soft of late, will perk up in the near future, adding thrust to overall economic activity.

Business Will Bounce Back

The gross national product figures reveal that business did not pull its weight in the third quarter. Nonresidential fixed investment decreased by $2½ billion in the third quarter, adjusted for inflation, after increasing nearly $7½ billion in the second. The decline was fairly widespread. Producers durable equipment purchases decreased by $1½ billion while spending on nonresidential structures fell by $1¼ billion. Considering the surge in capital spending in 1984, when such outlays rose by the fastest rate in 20 years, a slowdown in 1985 was to be expected. Add to this the sluggishness of the goods-producing sector of the U.S. economy caused by the overvalued dollar and you can see why business spending turned soft.

In addition, uncertainty over the tax reform issue has also affected business spending. Many corporate chieftains report that their firms are holding back on capital spending because they are concerned about what tax reform might do to the viability of such investments. As noted in the May 1985 Economic Report, doing away with the Accelerated Cost Recovery System and the investment tax credit will increase the cost of capital, decrease corporate liquidity, and thus will make capital investment less attractive. And this is not just one economist's opinion alone: It is the one issue on which economists of all stripes—Keynesians, monetarists and supply-siders—seem to agree.

But even here there are some bright spots. First of all, it is generally agreed in and out of Washington that tax reform is dead for 1985 and quite possibly for 1986 as well. The Administration does not appear to have lit a fire under the public at large or its major economic groups on this issue. People seem to think that, in view of Washington's budget deficits, the government simply doesn't have the money to give to them in the form of lower taxes without taking something away at the same time. Indeed, besides the issue of protectionism (Economic Report—September 1985), deficit reduction appears to be a higher priority item across the U.S.A. than tax reform. As it becomes apparent that tax reform is not in the cards, business will dust off some of its capital spending plans and put them into operation. Continued growth in consumer spending—especially as the lower-valued dollar channels more into domestically-produced goods—will also give businessmen a reason to re-examine their capital spending plans.

One aspect of business spending appears ready for change. The liquidation of business inventories over the summer has taken the ratio of inventories to sales down to 1.35. This means it would take 1.35 months to deplete inventories at the current selling pace—not a very long period of time, when you consider that the lowest this ratio has reached in the postwar era is 1.30. In other words—if spending continues to grow, business will run the risk of losing sales and market share unless it rebuilds

October, 1985
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual			Projected >								
	1985				YEAR 1985		1986				YEAR 1986	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3810.6	3853.1	3916.1	3993.1	3893.2	6.3	4067.6	4135.2	4219.2	4317.5	4184.9	7.5
GNP: $72	1663.5	1671.3	1684.8	1701.2	1680.2	2.5	1718.6	1732.5	1746.8	1764.6	1740.6	3.6
% Change, Annual Rates	0.3	1.9	3.3	3.9	2.5		4.1	3.3	3.3	4.1	3.6	
Consumption	2446.5	2493.0	2536.5	2582.2	2517.1	7.5	2641.0	2684.7	2737.7	2787.5	2712.7	7.8
Durables	334.8	339.2	355.6	362.6	348.8	9.2	374.1	379.7	384.4	388.5	381.7	9.7
Non-Durables	877.3	891.9	895.6	910.1	893.7	4.3	922.4	933.2	945.6	950.9	940.5	5.2
Services	1234.4	1261.9	1285.3	1319.5	1275.3	9.4	1344.5	1371.7	1407.8	1438.2	1390.6	9.0
Investment	646.8	643.2	622.8	641.4	638.6	0.1	660.3	673.1	683.4	707.2	681.0	6.6
Non-Residential	450.9	467.3	467.5	476.5	465.6	9.4	481.2	489.1	499.7	509.4	494.9	6.3
Producers Durable Equipment	288.0	299.0	300.6	307.5	298.8	8.5	311.2	317.9	327.5	335.8	323.1	8.1
Structures	162.9	168.3	166.8	169.1	166.8	10.9	170.0	171.2	172.2	173.7	171.8	3.0
Residential	155.2	158.0	163.4	162.6	159.8	3.8	166.8	169.7	171.4	172.5	170.1	6.5
Inventory Changes	40.7	17.9	−8.1	2.3	13.2		12.3	14.2	12.2	25.2	16.0	
Net Exports	−74.5	−94.0	−89.2	−90.9	−87.2		−85.5	−85.2	−78.5	−69.5	−79.7	
Government Purchases	791.9	810.9	845.9	850.4	824.8	10.4	851.7	862.7	876.6	892.3	870.8	5.6
Federal Defense	233.9	241.1	253.1	250.9	244.8	10.5	255.3	259.3	265.8	270.6	262.8	7.4
Federal Civilian	85.9	83.2	93.9	92.1	88.8	20.1	80.1	77.8	75.8	76.4	77.5	−12.7
State & Local	472.0	486.7	498.9	507.3	491.2	8.7	516.3	525.6	535.0	545.3	530.5	8.0
Final Sales: $72	1644.4	1663.6	1686.9	1700.1	1673.6	3.7	1713.3	1726.6	1741.7	1754.7	1734.1	3.6
% Change, Annual Rates	−0.3	4.6	5.9	3.2	3.7		3.2	3.1	3.6	3.0	3.6	
Domestic Demand: $72	1691.9	1705.1	1718.8	1733.8	1712.4	3.5	1746.0	1755.5	1763.9	1776.3	1760.4	2.8
% Change, Annual Rates	3.9	3.2	3.3	3.5	3.5		2.8	2.2	1.9	2.9	2.8	
GNP Price Index (1972 = 100)	229.1	230.5	232.4	234.7	231.7	3.7	236.7	238.7	241.5	244.7	240.4	3.8
% Change, Annual Rates	5.4	2.6	3.3	4.0	3.7		3.4	3.4	4.9	5.3	3.8	
Consumer Price Index (1967 = 100)	317.8	321.1	323.0	325.8	321.9	3.5	328.9	332.3	336.5	340.8	334.6	3.9
% Change, Annual Rates	3.3	4.2	2.4	3.5	3.5		3.9	4.2	5.1	5.2	3.9	
Total Personal Income	3143.8	3174.7	3199.1	3266.1	3195.9	6.1	3322.8	3387.6	3473.8	3546.1	3432.6	7.4
Disposable Personal Income	2654.8	2726.5	2712.6	2768.4	2715.6	5.4	2817.0	2868.3	2936.5	2993.9	2903.9	6.9
Savings Rate	4.5	5.1	2.9	2.7	3.8		2.5	2.6	3.0	3.1	2.8	
Employment Rate	58.5	58.3	58.4	58.6	58.4		58.7	58.8	59.0	59.2	58.9	
Unemployment Rate	7.3	7.3	7.1	7.1	7.2		7.0	6.9	6.9	6.8	6.9	
Indus. Production (1977 = 100)	123.8	124.2	124.5	127.4	125.0	2.8	128.7	129.5	129.9	130.8	129.7	3.8
Housing Starts (000)	1795.0	1771.7	1864.0	1786.8	1754.4	−0.7	1782.6	1769.9	1776.1	1782.0	1777.7	1.3
Domestic Auto Sales (000)	8454.7	8238.3	9440.7	8132.4	8566.5	7.7	8015.1	8027.3	7546.5	7758.4	7836.8	−8.5
Corporate Pre-Tax Profits	222.3	221.0	211.0	223.7	219.5	−6.9	239.3	246.2	250.4	270.2	251.5	14.6
− Taxes	85.3	83.6	75.3	81.6	81.4		91.5	94.2	95.7	106.7	97.1	
Net Profits	137.0	137.4	135.7	142.2	138.1	−5.4	147.7	152.0	154.7	163.4	154.5	11.9
− Dividend Payments	84.5	85.6	86.4	87.5	86.0	6.8	89.3	91.4	93.8	96.0	92.6	7.7
Undistributed Profits	52.5	51.8	49.3	56.9	52.6	−19.5	58.9	60.9	66.4	70.6	64.2	21.9
+ Depreciation	326.5	336.6	349.0	361.4	343.4		365.8	370.2	374.0	377.5	371.9	
− Inventory Profits	−0.9	−2.5	−6.0	10.7	0.3		14.9	15.8	22.1	24.8	19.4	
Net Cash Flow	379.9	390.9	404.3	407.5	395.7	9.4	409.8	415.2	418.2	423.3	416.6	5.3

inventories. And since the only thing worse than losing sales for lack of business is losing sales for lack of merchandise, it is not unreasonable to expect business to increase its outlays on inventories in the near future.

Another reason to expect a pickup in economic growth stems from the drop in the value of the dollar on foreign exchange markets. Between the end of February and the end of September the dollar declined by 15 percent against a market basket of major currencies. This was enough to stem the rise in our deficit in foreign trade. In July and August the red-ink total narrowed by more than 20 percent compared with the immediately preceding two months.

The announcement by the finance ministers of the five leading industrial countries (G-5) that they were dissatisfied with the value of the dollar in foreign exchange markets and that they would intervene from time to time to force it lower resulted in a further decline of around five percent. Even if the dollar moves no lower, the trade deficit will shrink further as imports slowly become more expensive and exports become cheaper overseas. This will give a lift to domestic business, but it will still leave us with a sizable trade deficit, thus vulnerable to protectionist pressures. It is safe to say that the central bankers will make further attempts to get the dollar lower if it shows no tendency to go lower by itself. The lower the dollar, the more of a lift to our domestic economy, since more and more of domestic spending will be channelled into domestically produced goods.

Have We Seen Inflation's Lows?

Now for the bad news. We may have seen the low point in the inflation rate. Aside from the recessions we went through in 1980 and again in 1981-82, the key reason why inflation has been held down this long into the business upswing has been the overvalued dollar. Calculations by this Bank suggest that each ten percent that the trade-weighted value of the dollar increased between July 1980 and February 1985 reduced our annual rate of inflation by one percentage point. The 20 percent drop in the value of the dollar over the past eight months alone is good for at least one percentage point more inflation next year, if not two. And should the dollar move even lower, the rate of inflation will pick up even more.

On the monetary side, there is certainly plenty of liquidity around that could fuel a higher rate of inflation. The narrowly-defined money supply (M1) will probably rise this year by the fastest rate for any year in postwar history. The broader aggregates, M2 and M3, are rising more slowly than M1, but their growth rate is also high compared with their own historical trends. It is hard to see how the Fed can avoid even faster rates of monetary growth, now that the dollar has come down. This is because the demand for funds from both the private and public sectors remains strong, while the lower-valued dollar, by definition, means that there are less foreign funds coming into the U.S. for investment in financial assets.

To be sure, the rate of inflation will not pick up right away. The table suggests that the consumer price index will go up at its recent rates for at least a couple of more quarters. However by this time next year, the CPI is likely to be rising at rates of five percent or better. Looking even further ahead, other factors such as a tightening of the labor markets, a higher rate of capacity utilization, the reappearance of inflation psychology combined with continued economic growth—not to mention additional fiscal and monetary stimulus—should force the inflation rate even higher in 1987. Double-digit inflation is not in the cards for 1986, but I would not rule out that possibility for 1987 or later.

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